BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

TAX NEWSLETTER

September 2012

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WOULD YOU LIKE SOME TAX-FREE INCOME?

There are several kinds of income or benefit that are not subject to tax under the *Income Tax Act*. To the extent you can get one of these, you won't need to report the income or pay tax!

Here are some of the kinds of income that are not taxed, based on the provisions of the *Income Tax Act*, CRA publications or court decisions:

- Strike pay from a union. (Supreme Court of Canada, 1990 decision in *Fries v. The Queen*) A union's cash gift to a member is also usually tax-free.

- Damages or compensation for personal injury, including structured settlements and awards from a provincial Criminal Injuries Compensation Board.

- Compensation for mental or emotional damage at the workplace, such as harassment of an employee, or for human rights violations.

- Lottery or other gambling winnings, unless you are so organized and active in your gambling that it constitutes a "business" from which you could deduct losses if you lost money.

- Television game show prizes.

- Gifts (provided they are not disguised employment income or business income).

- Capital gains on your principal residence, subject to various rules that ensure that your family has only one "principal residence" at a time. However, if you build a home to sell, but move in first, this exemption will not be available because your gain will be business profit, not capital gain. (*Income Tax Act* paragraph 40(2)(b)).

- Income of a "status Indian" earned on a reserve. If you aren't a status Indian, this exemption doesn't help you!

- Welfare and similar social assistance payments. These must be reported as income, but an offsetting deduction is available when calculating taxable income.

- Workers' compensation benefits. These must be reported as income, but an offsetting deduction is available when calculating taxable income.

- Most grants under government programs, unless the program has been prescribed in the *Income Tax Regulations* as taxable, or it relates to your business.

- Reimbursements of expenses to volunteers, and reimbursements to parents for the cost of transporting students to school when a school board discontinued bus service.

- Damages for breach of an employment contract before it began. (Supreme Court of Canada, 1996 decision in *Schwartz v. The Queen*)

- Certain employment benefits (see CRA guide T4130, available on cra.gc.ca), as we discussed most recently in our December 2010 letter. A few examples are:

  — Your employer's contributions to your registered pension plan, or a private health services plan.

  — Your employer can give you up to $500 in non-cash gifts and awards per year, such as for a birthday or Christmas. As well, a separate non-cash "long service" or "anniversary" award of up to $500 can be non-taxable; it must be for at least five years of service or five years since the last such award.

  — Board and lodging at, and transportation to, a "special work site" where you work temporarily, or a "remote work site" that is remote from any established community.

  — Transportation to the job, if provided directly by the employer.

  — Uniforms, special clothing or safety footwear that you need for your job.

Examples of how to save tax by planning for tax-free income

1. Suppose you are fired from your job in circumstances where you suffer emotional trauma.

   If you sue for "wrongful dismissal" and reach a settlement with your employer, the settlement will be taxable.

   If instead you sue not only for "wrongful dismissal", but also for emotional injury and/or violation of your human rights, you may be able to have at least part of the settlement classified as compensation for your personal (emotional) injuries or human rights violations. This portion of the settlement will be non-taxable, provided you can convince the CRA that it really is compensation for injury (or human rights violation) and not just a disguised settlement of a claim for losing your job.

2. Suppose you have a choice of employment benefits from your employer. You can choose between a company car or a health care plan (drug and dental). The two packages cost the same to your employer, so the employer does not care which one you choose.

   If you choose the company car, that is a taxable benefit. You will be required to report, as employment income on your tax return, a "standby charge" of 2% of the original cost of the car, or 2/3 of the leasing cost, each year, plus an amount for operating costs if the employer pays those. (These figures will be included in your T4 and so will be included in your employment income for tax purposes.) Therefore, you will pay tax on this benefit.

   If you opt for the health care plan, you will not have a taxable benefit, either when the employer pays the premiums for the plan or when you receive health care benefits such as reimbursement for drugs or dental care. Thus, you will have a lower income tax bill.

Note however that if you do opt for the company car, and then you end up spending a large amount on prescription drugs and dental care, those costs will qualify as medical expenses for tax purposes (though only to the extent they exceed 3% of your net income or $2,109 [for 2012], whichever is lower). So you may still get some tax relief, though the medical expense credit is generally worth only about 21%, which for taxpayers in a high tax bracket is significantly less than a deduction from income.

3. Long-term planning: You can choose between buying a home to live in, or continuing to rent a home and investing your money.

   If you invest in securities, the return on your investment will normally be taxable, whether fully taxed as interest income, partly taxed as dividend income, or half-taxed as capital gains. The rent you pay to rent a home is not deductible (except to the extent you have a home-based business).

   If you “invest” in your own home to live in, and sell it for a gain in 5 or 10 years, then the capital gain will be tax-free.

   Of course, it can be hard to predict whether residential home values will increase at the same rate as the return you can obtain by investing. But of course it’s also hard to predict what those stocks and mutual funds will do for you in 5 or 10 years!

CHARGING GST OR HST ON DISBURSEMENTS

Are you in a business or profession where you charge disbursements or expenses to your clients? If so, you need to understand how to treat the GST and HST. Otherwise, you can easily end up with a costly GST/HST assessment — or you could be cheating your clients!

When putting disbursements on your bill to a client, you must first determine whether the disbursement was incurred “as agent” of the client. **This determination is crucial, and you must be clear as to the answer** before you issue your invoice.

The CRA has published Policies P-209R, “Lawyers’ Disbursements”, and P-182R, “Agency”, to help with this determination (they are available on cra.gc.ca). For example:

- Travel expenses, postage, telephone, couriers and photocopying are not normally incurred as “agent”. They are your own expenses, and are inputs to (part of the cost of) the services you provide.

- Paying an expense which is really the client’s own expense is a payment made as “agent”. For example, when a lawyer pays land transfer tax on behalf of a client who is purchasing a home, that payment is made as the client’s agent.

If the expense is not incurred as agent

An expense that is not incurred as an agent (e.g., travel) is considered an **input** to your services. **You should claim any input tax credit yourself** on such an expense. You then bill the pre-GST/HST amount of the expense as a disbursement, added to your fee before charging GST or HST. If you charge GST/HST on your services, you then charge the tax on the total including the (pre-GST/HST) disbursement.

EXAMPLE

You travel on a client matter and pay a Calgary hotel bill of $100 plus $5 GST. You want to have the client reimburse you. You are charging $1,000 to the client for your work. The client is in Alberta, so you are charging 5% GST rather than HST.

You should claim the $5 GST as an input tax credit on your own GST/HST return, and record the disbursement as $100, not $105.

You then bill the client as follows:

Fees	$1,000.00
Disbursements: hotel	100.00
Subtotal	1,100.00
GST @5%	55.00
Total	1,155.00

The net result may appear to be the same as simply charging $105 to the client as the disbursement (in addition to your fee of $1,000 plus $50 GST), and not adding GST to the disbursement. However, if you do that, the CRA can assess you for not collecting GST on the disbursement! (You may or may not be able to claim the offsetting input tax credit if that happens.)
Note also that with this method, taxable disbursements can become non-taxable or taxable at a different rate, and non-taxable disbursements can become taxable. What matters is the GST or HST status of your fees, not what rate of tax you paid on the expense you incurred.

Thus, suppose in the above example you are billing a non-resident client and not charging GST on your services. Your subtotal would still be $1,100, with no GST on top, for a total bill to the client of $1,100. Meanwhile, you have properly claimed the $5 input tax credit. As a result, no net GST applies to the hotel bill you paid. The $100 hotel bill is included in your disbursements and the client does not pay GST on it.

Conversely, suppose your client is in Ontario, so you charge the client 13% HST on your services. Your subtotal would again be $1,100, but 13% HST applies to the entire amount. As a result, the Calgary hotel bill (originally $100 + $5 GST) is rebilled by you as $100 plus $13 HST. Since the hotel bill was an input to your services, not an expense you incurred as agent of your client, this is the correct result. The client effectively pays $113 for your hotel stay. (If the client is a business claiming input tax credits, it will claim a credit for the $13, along with the HST in your fees.)

If the expense is incurred as agent

An expense that is incurred as agent is simply a “pass through”. You show it on your invoice *after* all GST/HST is calculated, and you include whatever GST or HST was on the expense — or nothing if there was none. You do not claim an input tax credit for the GST or HST charged on the expense, because you did not incur the expense — you simply paid it as your client’s agent. You also do not add GST or HST to the disbursement. The client pays whatever GST or HST was originally charged. In effect, it’s as though you weren’t in the picture and the client incurred the expense directly.

Thus, for expenses incurred as agent, the original GST/HST status is preserved and passed through to the client.

Conclusion

If you have been reporting GST/HST on disbursements incorrectly in the past, it may

be possible to eliminate any net cost by way of a Voluntary Disclosure. This is best done with the assistance of a knowledgeable tax professional.

REQUEST A DETERMINATION IF YOU HAVE A LOSS

If you have a business or property loss that wipes out all of your income for the year, you report taxable income on your income tax return as zero.

What happens if the CRA audits you some years later and decides that you claimed too much loss?

For a regular assessment of tax, there is a "three-year clock" that starts running as soon as the CRA issues your original assessment for the year.

Thus, for example, if you filed your 2009 return on April 6, 2010 and you received a Notice of Assessment dated April 22, 2010, then the CRA cannot reassess you to change your 2009 taxable income after April 22, 2013. (This limitation does not apply in cases of fraud, carelessness, neglect or wilful default, or if you sign a waiver before the deadline.)

But what if you had a business loss in 2009, reported zero taxable income and zero tax, but also had a $50,000 loss carryforward to claim in a later year? And suppose the CRA decides, many years later, that the $50,000 loss shouldn't be allowed?

<u>The three-year clock will not start running for a loss</u>, since your "assessment" — i.e., zero tax for 2009 — does not change. Thus, for example, if you try to use the $50,000 loss from 2009 on your 2012 return, the CRA can reassess you to deny the claim, any time up to the reassessment deadline for your 2012 return (sometime in 2016), rather than only until April 2013.

There is a way to prevent this, however, and to start the clock running. Once you receive your "nil assessment" for the year in which you pay no tax, write to the CRA and request a **determination of loss** under subsection 152(1.1) of the *Income Tax Act*. The CRA will usually comply and issue the determination fairly quickly. Once it is issued, the date on the Notice of Determination starts a three-year clock running for any redetermination. If the three years run out, then your loss is guaranteed and (subject to exceptions for fraud etc. as mentioned above) you can be sure of being able to carry it forward and claim it in a future year. Business losses can now be carried forward up to 20 years.

So, if you have nil taxable income for the year and a loss carryforward, request a "determination of loss".

EMPLOYER-PROVIDED CHILD CARE

Employers are increasingly providing child care at the workplace. This can be a great benefit to employees, giving them more incentive to come to work, as they can see their children during the day and not have to worry about more complex child-care arrangements.

There are a number of tax benefits available for employer-provided child care.

First, such child care is considered a **non-taxable benefit** by the CRA if it meets certain conditions. (If you want to look this up, see Guide T4130, *Employer's Guide — Taxable Benefits and Allowances*, available on <u>cra.gc.ca</u>.) The conditions are:

- The child-care services are provided at the employer's place of business.
- The services are managed directly by the employer.
- The services are available to *all* employees at minimal or no cost.
- The services are not available to the general public, only employees.

Second, there is an **investment tax credit for new child-care spaces**. The credit is for employers who create licensed child care spaces for the children of their employees and, potentially, for other children. The credit is **25% of eligible expenditures** incurred, to a maximum of $10,000 per child-care space created in a licensed facility. The credit is *not* for businesses that are in the business of providing child-care; it is for other businesses that set up child care for their employees. The credit is "non-refundable", meaning it can reduce the employer's federal tax payable for the year but not below zero.

Eligible expenditures for this investment tax credit include the cost of the building or portion of the building in which the child care facility is located, as well as the cost of furniture, appliances, computer equipment, audio-visual equipment, playground structures and playground equipment. Allowable start-up costs for the credit include landscaping costs for a playground, architect's fees, initial regulatory inspections, initial licensing fees, building permit costs and costs to acquire children's educational material.

This incentive may help encourage more employers to provide child-care on their premises. Consider asking your employer about it!

Finally, the *Income Tax Act* provides a **deduction to parents** for the cost of child care. (This is the regular deduction, not specific to employer-provided care.) The deduction can be claimed only by the lower-income spouse, and is subject to specific dollar limits and limited to 2/3 of the lower-income spouse's "earned income".

AROUND THE COURTS

CRA cannot settle an appeal unless there's a "principled" basis

Have you ever been in a dispute with the CRA over some technical tax matter?

If the question is a yes/no one, such as whether tax applies or not in the particular situation, you will find that the CRA will refuse to "settle" the case, in the way disputes between parties are often settled by splitting the difference. This is true at every stage: audit, objection and Tax Court appeal.

This issue arose when CIBC World Markets (CWM) had a GST dispute with the CRA. The issue was whether CWM could change its method of calculating its GST input tax credits for a year when claiming those credits in a later year. This was a "yes/no" question: either CWM was right, or it was wrong.

The Federal Court of Appeal ruled in September 2011 that CWM was right.
CWM then went back to the Court to ask for most of its lawyers' fees to be paid by the CRA, because it had made a settlement offer and did better than that offer at trial. (Most courts now have this rule: if you make a formal offer to settle the case and leave it open until trial, the other side does not accept and you do better at trial, the court

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will generally order that the other side pay most of your legal fees from the time you made the offer.)

However, the Federal Court of Appeal ruled that **the CRA was not legally allowed to accept CWM's offer**. That offer was for 90% of its input tax credits in dispute to be allowed. There was no legal basis justifying an assessment allowing 90% of the credits. The CRA could only allow 100% of them, or none of them. Since the CRA was not allowed to accept the offer, the offer did not trigger the usual consequences in legal costs.

As a result, CWM was awarded only the normal "tariff" costs for its appeal, which would be only a tiny fraction of its actual costs.

So be aware of this rule if you're in a dispute with the CRA. Often there's a way to craft a settlement by trading off one issue against another, or to settle an issue such as valuation by picking a middle ground. In some cases, however, the only settlement possible is all-or-nothing, and the CRA will not be able to accept anything in between.

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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.