TAX NEWSLETTER

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YOU CAN BE LIABLE FOR A FAMILY MEMBER'S TAX DEBTS!

Beware of getting money, gifts or transfers of property from a family member, including your spouse, if that person owes (or might possible owe) any money to the Canada Revenue Agency (CRA), for either income tax or GST.

The CRA has the ability to **trace property or money that is transferred** to anyone with whom the debtor does not deal "at arm's length" — which includes any close family member (and depending on the circumstances can also include friends).

If a tax debtor transfers money or property (e.g., cash or the family home) to you, during a year in which, or for which, the debtor owes money to the CRA, or during any later year, the government can assess you under section 160 of the *Income Tax Act* for the net value of what you have received. (The same general rule applies under section 325 of the *Excise Tax Act* for any GST or HST the tax debtor may owe.)

The debt to the CRA could arise in various ways, such as:

- the debtor's own income tax
- a failure to remit payroll withholdings (source deductions) or GST collected by a person carrying on business
- a director's assessment for the failure of a corporation to remit source deductions or GST/HST.

EXAMPLE

Richard and Linda jointly own their home, which is worth $200,000 and is mortgage-free. In September 2016, Richard transfers his half-interest in the home to Linda, so that she now owns all of it.

Richard is a director of a corporation with a December 31 year-end. In November 2016, the business starts running into financial trouble, and it uses $130,000 in employee source deductions and GST/HST collections to pay creditors rather than remitting the funds to the CRA. Eventually the corporation goes bankrupt, leaving a trail of unpaid creditors including the CRA.

The CRA will be able to assess Richard for $130,000, as a director of the corporation, for the unremitted source deductions and GST. To escape liability he will normally have to show that he "exercised the care, diligence and skill that a reasonably prudent person would in comparable circumstances" (the "due diligence" defence).

Suppose Richard is found liable, but he has no assets to pay the $130,000?

The CRA can assess Linda under section 160 for $100,000 — the value of what Richard transferred to her, since the transfer took place during the same year.

She will be personally liable for this amount, and if she has no other assets, the CRA will register a lien against the home (and could even force it to be sold). **Richard has thus made things much worse by transferring the house** to Linda. All of her assets are now subject to seizure, not just the home.

Linda can be assessed at any time — even 5, 10 or 20 years after Richard's liability arose. **There is no limitation period on this assessment**.

As noted above, the transfer need not be to a spouse to be caught. Transfers to other family members will fall into the net. So can transfers from a corporation to a shareholder.

Here are some other examples of cases where this rule has been held by the Courts to apply — some of them surprising:

- David and Diane live in a home that is registered in Diane's name (and has been for years). David is the sole income earner in the family. David makes all the **mortgage payments** on the home. He is reassessed for income tax of an earlier year.

  The mortgage payments can be considered a transfer of money from David to Diane, so Diane can be assessed for David's tax debts. (Some court cases have allowed a reduction for the value of the free rent David has received from Diane, but others have not.) If she doesn't have any money, the CRA may put a lien on her home.

- Mary is the sole shareholder of MaryCo, a small business corporation. MaryCo pays a $20,000 **dividend** to Mary. MaryCo ends up without enough money to pay its $15,000 tax owing for the year. The CRA tries to collect the debt from MaryCo but is unable to.

  The CRA can assess Mary for the transfer of property from the company by way of dividend. Mary will likely be liable for $15,000 — even though she has already paid income tax on the $15,000 dividend!

- Len is a majority shareholder of LenCorp, a corporation. Len owes $10,000 to Karen from a personal loan. Len arranges for LenCorp to pay $10,000 to Karen to **pay off Len's debt**. LenCorp is then unable to pay its income tax or make its GST remittances for the year.

  The CRA can assess Len for up to $10,000 of LenCorp's tax debts. The payment to Len's creditor (Karen) is considered to be a transfer of money to Len. (It will also be taxable to Len as a $10,000 shareholder benefit.)

- Keith **leaves Canada** and moves to the Bahamas with unpaid tax debts. The CRA cannot enforce its claim because he is outside Canadian jurisdiction, though they periodically contact him to ask him to pay. Twenty years later he dies, leaving money to his children, who still live in Canada. The CRA can assess the children to collect the ancient debt owing by Keith, plus 20 years' interest — perhaps seizing their entire inheritance.

- Kevin transfers property to his brother Malcolm and then goes **bankrupt**. The bankruptcy wipes out Kevin's tax debts — but it does not wipe out Malcolm's debt. (However, if the bankruptcy took place *before* the transfer of property, then there is no liability because Kevin was not liable for tax at the time of the transfer.)

- Sally **pays for her daughter's wedding**, at a time when she has a large debt to the CRA. Her daughter will be assessed for the amount Sally paid towards the wedding.

Exceptions

There are some exceptions to the "tracing" rule in section 160.

First, the rule does not apply to the extent the transferor **receives consideration** for the property transferred. Thus, in the first example above, if Linda had paid Richard $30,000 for the $100,000 interest in the home that he transferred to her (or if the transfer paid off a previous loan of $30,000 Linda had made to Richard), then the CRA would only be able to assess Linda for $70,000 — the net value of what he transferred.

Second, the rule generally does not apply to a transfer on **marriage breakdown**, if the transfer takes place under the terms of a court order (e.g., a divorce decree) or a written separation agreement. Thus, if Richard transferred his interest in the house to Linda because they had separated or were divorcing, the CRA might not be able to assess Linda. These rules apply to common-law partnerships as well as legal marriages.

Be Careful!

CRA collections officers will actively pursue transfers by delinquent taxpayers. For example, they will search real estate transfer records, banking records and other sources to find transferees that can be assessed.

So if you are offered a gift of money or transfer of property by a family member, or even an inheritance — be careful! The gift could come with strings attached, in the form of a future assessment from the CRA.

A TIP IF YOU HAVE A CORPORATION AND NO EMPLOYMENT INCOME

If you report no employment income (including income from being a director of a corporation), but you have a corporation that pays you either dividends or as an independent contractor*, here is a small planning tip.

The "Canada Employment Credit" in subsection 118(10) of the *Income Tax Act* gives you a federal tax credit of 15% against your first $1,161 of employment income (the amount is indexed to inflation every year). This year, it's worth $174.

If you arrange to take a small amount of employment income from your corporation (say $1,200), perhaps as a director's fee (which is reported as income from an "office or employment"), you can benefit from this credit. You'll still pay the balance of the federal tax on the income, and provincial tax, but your effective tax rate on that $1,200 will be 15 percentage points lower because of this credit.

* **A caution** if you are getting income from your corporation as self-employment income (i.e., as an independent contractor): you need to check carefully, with professional advice, that you are reporting this income correctly. The Canada Revenue Agency often takes the position that a company owner/manager who earns income from the company for work done is an employee. If this happens, the CRA will assess the company penalties for failing to withhold income tax from your pay, as well as Canada Pension Plan employer and employee contributions. There are many Court cases holding that an owner/manager was an independent contractor to the corporation, but there are just as many going the other way. Each case must be carefully examined

to consider the facts of the actual working relationship between you and the company.

BANKS MUST ACCEPT CHEQUES FOR INCOME TAX PAYMENTS

Some Canadian chartered banks have recently stopped accepting cheques for payment of third-party bills (such as property taxes and utilities). They require such payments to be made electronically.

However, section 229 of the *Income Tax Act* provides:

> A chartered bank in Canada shall receive for deposit, without any charge for discount or commission, any cheque made payable to the Receiver General in payment of tax, interest or penalty imposed by this Act, whether drawn on the bank receiving the cheque or on any other chartered bank in Canada.

This means that your bank cannot legally refuse to accept, without charge, a cheque that you provide for payment of an income tax instalment or debt. In practice, GST/HST remittances are also accepted by the banks.

NON-COMPLIANCE IN THE REAL ESTATE SECTOR

The real estate sector is a major area of attack for CRA auditors. Because the dollar amounts involved in real estate transactions are very large, the "profit" to the CRA on any file can be very substantial. Both income tax and GST/HST assessments can be extraordinarily expensive for the person assessed.
The CRA's main areas of concern in real estate are the following:

Questionable source of funds

The source of funds used to buy or maintain Canadian properties could be an unreported source that was never taxed, either in Canada or another country. A large down payment on a home, or a property that is expensive to maintain, may be an indication of unreported income, tax evasion, or even a purchase by a low-income person hiding a wealthy buyer.

Buying a high-end home, without an obvious income source, is a flag to the CRA of potential unreported income earned from legal or illegal sources.

Property flipping

If someone buys a home or condo and then sells it soon after, the CRA considers that person to be "flipping". If the intention on buying was to resell for a profit, the property is not "capital property" for income tax purposes. The profit is fully taxed as business income. The principal-residence exemption does not apply, even if the person moved into the home and lived there for a period of time.

The CRA sometimes gets this wrong. A buyer who buys a condominium pre-construction might not be able to close the purchase for several years due to construction delays. In the meantime, the buyer's circumstances may have changed. Still, if you *actually own* the condo for less than a year after the closing, the CRA will generally assume you intended to sell it, and will reassess you on the basis that your gain on the condo was business profit. You might be able to convince the CRA or the Tax Court otherwise, but the process will be financially and emotionally draining.

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, GST or HST on the new home (including the land value), interest and substantial penalties. Of course, real estate records are easily available to the CRA, so the CRA can always find out who bought a property, when and for how much. And if the CRA believes that the taxpayer deliberately or negligently failed to report the income, there is no time limit for the CRA to reassess the taxpayer.

GST/HST on sale of a new (or substantially-renovated) home

If you build or “substantially renovate” (gut and redo) a home, then GST or HST applies when you sell the home. If instead of selling it you move in, or you rent it out, you have what’s called a “self-supply” and are required to pay to the CRA the GST or HST on the *entire* fair market value of the home including the land. (You can claim back the GST/HST you paid on construction as input tax credits, *if* you have kept all your receipts.) There is an exception if you were genuinely building the home for your own residence, and not as a business venture — but you will have to convince the CRA of that.

If the CRA comes after you for building or renovating a home, also expect an expensive GST/HST assessment on top of the income tax assessment The combined cost can be devastating.

GST/HST new housing rebates

The GST/HST new housing rebate will refund to you up to $6,300 of the 5% GST on a new home or condo, plus up to $24,000 of the Ontario portion of the HST, if the property is in Ontario.

One of the main conditions for the new housing rebate to be available is that you must buy or build the house for use as your (or a close relative’s) **primary place of residence**.

If you buy or build a new house in Canada, but your primary place of residence remains outside Canada, then your house in Canada would be a secondary place of residence and would not qualify for the new housing rebate.

Also, if your intention at the outset is to flip the property, you don’t qualify for the rebate, because even if you live in the home, it’s considered part of your inventory, not your “primary place of residence”.

The CRA has been assessing taxpayers to recover the new housing rebate in these situations.

Unreported capital gains

The sale of a property for an amount greater than its cost generally leads to a capital gain. In most cases, capital gains are taxable and must be reported to the CRA. Whether the capital gain is taxable or not can vary, depending on whether the property is a principal residence and where the taxpayer is resident.

If the seller of a property has lived in Canada, and during that period the property was their principal residence, they may avoid having all or part of the tax on the gain on selling the

property, due to the principal residence exemption. However, as noted above, if they bought the home with an intention (or even a "secondary intention") of selling it, the gain is business profit and they cannot claim the principal residence exemption.

A **non-resident** who invests in real estate in Canada is liable to pay tax on gains that arise from the sale of the property and is generally not eligible for the principal residence exemption. There are rules related to the disposition or acquisition of certain Canadian property that require non-residents who sell Canadian property to notify the CRA and to pay an amount to cover their estimated Canadian tax liability. This protects the Canadian government's ability to collect tax that would otherwise be payable upon the sale of a property.

Unreported worldwide income

An individual's residency status is critical in establishing their Canadian tax liability and the tax treatment of their worldwide income. Residency status should not be confused with citizenship. For example, a citizen of a country other than Canada who has significant residential ties in Canada may be deemed to be a resident of Canada.

Residents of Canada have to report their **worldwide** income to the CRA, while non-residents only have to report their Canadian-source income, unless a tax treaty provides otherwise. An individual's residency status is therefore essential in determining what income must be reported.

An individual's residency status is determined on a case-by-case basis in light of many facts which include:

- residential ties in Canada;
- purpose and duration of visits outside Canada; and
- social and economic ties outside Canada.

Real estate records are often a way for the CRA to start an audit of an individual that expands into looking at the person's entire lifestyle. If the CRA believes that your lifestyle indicates your income is higher than you have reported, they will assess you for the missing income. Then it's up to you to provide you *didn't* earn that income! (Yes, the onus is on the taxpayer to disprove an income tax assessment.)

CRA audit activity in real estate

For the year April 2015 to March 2016, the CRA completed 1,339 income tax audits and 525 GST/HST audits in real estate. This resulted in assessments of more than $17 million of income tax — with over $9 million in penalties — and $32 million of GST/HST.

AROUND THE COURTS

Medical marijuana is subject to GST and HST, it seems

In *Gerry Hedges v. The Queen*, 2016 FCA 19, the Federal Court of Appeal recently ruled that medical marijuana was subject to GST.

The taxpayer sold marijuana to the British Columbia Compassion Club Society to provide to members who needed it for medical purposes. This was done outside the scope of the *Medical Marihuana Access Regulations*, which permitted certain people to legally buy and own marijuana. However, based on numerous Court cases, the Compassion Club and its patients were protected by the *Charter of Rights*, since access to marijuana is a legitimate health need for many patients.

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The taxpayer was assessed for not collecting and remitting GST on his sales. He argued that, based on a technical reading of a hard-to-read rule in the GST legislation, marijuana was "zero-rated" (i.e., tax-free) as a drug.

The Tax Court dismissed Mr. Hedges' appeal, and he appealed to the Federal Court of Appeal. The Court of Appeal did not address the technical arguments of the case, but simply ruled that Mr. Hedges' sales were "unlawful" and therefore could not be zero-rated. The Court of Appeal did not address the point that the sales were likely protected by the *Charter of Rights.*

So it appears that medical marijuana is subject to GST/HST — at least when its sale is unlawful. The status of medical marijuana sold "lawfully" is not yet clear, since the Federal Court of Appeal declined to address the legal arguments on that point.

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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.