TAXATION - LAW 504

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UNIT #1 - INTRODUCTION TO CANADIAN INCOME TAX

CONSTITUTIONALITY OF TAXATION

- The *Constitution Act 1867* addresses two key issues
  1. What kinds of taxes can be enacted by each government (ie. Federal & Provincial)
  2. How does the government validly enact such a tax?
- With respect to issue 1:
  - **Subsection 91(3)** provides that the Federal Government can raise money by "any mode or system of taxation"
    - More broad, as long as there is a sufficient connection to Canada
  - **Subsection 92(2)** provides that provincial government can impose "direct tax[es] within the province in order to raise revenue for provincial purposes"
    - More strict than federal
- With respect to the second issue, **sections 53** and **90** generally require the Federal and Provincial governments to enact taxes through their legislative branches (subject to the clarification below)
  - This principle often stated as "**no taxation without representation**" and has been found to (additionally) be a component of our "**rule of law**"

Questions
- Why do we require the legislative branch of government (as opposed to the executive branch (political party with most seats in power)) to enact tax laws?
  - b/c taxation is an invasive act (taking away a person's wealth without providing compensation in return, directly), we want to make sure the people responsible (in power) are held accountable for the taxes that they are taking. If the tax system is not favourable by the majority, governments can be voted out and taxes can be changed accordingly
- Does this mean that the Executive branch of government cannot create a tax?
  - No, it is possible for the executive branch to be **given the power** to enact some tax change by the legislative branch
  - And the executive branch cannot exceed the delegated power it has been given
  - S.221 of the Act gives the executive branch the ability to make changes and update components of tax law that are required to be updated on a yearly basis (so it does not clog up the legislative system)

DEFINITIONS

There are three types of takings: tax, fees , charges.

Tax
1. there is no definition of a "tax" in the *Constitution Act, 1867* or the *Income Tax Act*.
2. The *Oxford English Dictionary* defines a "tax" as **"a contribution to State revenue, compulsorily levelled on people, businesses, property, income, commodities, transactions, etc."**
   - Real life examples of Canadian Tax include:
     - Federal and provincial income taxes

        - Federal value-added (GST/HST) and provincial consumption taxes (PST)
        - Municipal property taxes
        - “Sin” taxes - alcohol, tobacco, gas, and now marijuana
        - Tariffs and custom duties, which are taxes imposed on the importation (or exportation) of a good or service
        - Transfer taxes (ie. on land)
        - Capital taxes - on the invested capital of a corporation

Direct Tax

- A direct tax is one that is demanded from the very person who it is intended or desired should pay it
- Examples:
    - Personal and corporate income taxes, and sales taxes

Indirect Tax

- An indirect tax is one that is demanded from one person in the expectation and with the intention that they shall indemnify themselves at the expense of another
- Examples:
    - Import duties that are paid by the importer and then included in the price to the ultimate consumer
    - Liquor taxes imposed on a business (but not individuals) with the intention that these taxes be recovered by the businesses by including this cost in the price to their customers → see e.g. *Kingstreet Investments v New Brunswick* [2007]

Note: whether tax is “direct” or “indirect” is only relevant when it is levied by a province, as the Federal government can generally enact any kind of tax it wishes

Excise Tax - taxes paid when purchases are made on a specific good such as gas. Often included in the price of the product. There can be excise tax on activities such as on wagering or on highway usage by trucks.

Tax Test

In ***Lawson v Interior Tree Fruit and Vegetable Committee of Direction*** [1931], the SCC defined tax as a charge that is:

1. **Enforceable by law**
2. **Imposed under the authority of the legislature by a public body**, and
3. **Imposed for a public purpose**
    - This requirement has generally been interpreted to mean that the charge is intended to raise (general) revenue for the government
    - Conversely, if the charge is designed to (within reason) only recover the costs of providing a good/service, then courts have typically found that the charge is not a “tax” but rather a “fee” and hence not subject to the constitutional requirements described above

Note: taxes apart of a regulatory scheme is a third category of taxes **regulatory regime**

TAX TRENDS

<u>Revenues from Taxation</u>

- For 2018/2019, the Federal government expects to collect approximately $323.4 billion in revenue in total
- Of this amount, roughly:

    - $161.4 billion comes from **personal income tax** (approximately 50% of the Federal government's total revenues)
    - $47.3 billion comes from **corporate income tax** (14.6%)
    - $37.7 billion comes from the **Goods & Services Tax (GST)** (11.7%)
    - $29.4 billion comes from **"Other Revenue"**
    - $21.7 billion comes from **Employment Insurance** premiums (6.7%)
    - $8.3 billion comes from the taxation of **non-residents**
- In contracts, provinces and territories collectively receive approximately **25% of total revenues** from **income taxes** - sales taxes and excise taxes on liquor, tobacco and fuel, etc.
    - Alberta gets less from such taxes since it is the last/only province without general sales tax
- They receive approximately 13% of total revenues from property taxes (which are generally levied by municipalities)

Question

1. Why do Parliament and the provincial legislatures impose a variety of different taxes? Why not just pick one and set the rates such that the government raises the same total revenues?
    a. Reasons for multiple tax streams:
        i. Provides more stability for the government for raising sufficient revenue (ie. if economy is not doing well people are making less and do not pay as much income tax)
        ii. Reduce the potential for individuals who might have the ability to contribute to society by avoiding their social contract to provide to society (ie. if there was only a taxation on income, ppl who are retired or who are not engaged in income earning activities b/c they already have a great deal of wealth, they do not contribute, makes it harder for people to avoid taxes)
        iii. Gives different governments their own revenue source that they can control (weak argument)

<u>**Evaluation Taxes and Tax Regimes**</u>

General Question: Given the variety of ways governments can tax (ie. incomes taxes, sales taxes, etc.) and the ways such taxes can be structured and administered, how do governments go about deciding how to tax and how can we evaluate such decisions?

At a very high level, taxes are often evaluated on 3 grounds:

1. Its ability to generate revenue for the government imposing the tax
2. How efficiently it generates the revenue
3. How fair/equitable it is

Revenue Generation:

- Obviously revenue is usually a primary goal of taxation (although not always)
    - In the case of "sin taxes" (ie. taxes on gas, alcohol, and cigarettes/marijuana), the primary (stated) goal is to reduce consumption by increasing the cost to the consumer
- Where a tax is evaluated under this ground, **a good tax (or tax regime) is one that generates the most net revenues** (ie. gross revenues less associated expense) for the government
- **Revenue = Tax Base x Tax Rate**
- Given this formula, if a government wants to increase its taxation revenues, it can either increase/broaden the Tax Base (ie. who or what is subject to tax) or increase the Tax Rate (or both)
- Federal Carbon Tax

    - Common criticism - if you are going to impose a tax but then give majority people revenue (tax credit) then what is the point of this

Efficiency:

- Two key elements (measures) of efficiency (but by no means is this comprehensive) that we will briefly discuss in the course are:
    1. How the existing income tax provisions (and changes to the regime affect **taxpayer's behaviour**
    2. How **costly our income tax regime is to administer** - to either the taxpayer, the government or both
- Focusing on the 1st measure, the **less a tax influences a taxpayer's behaviour the more efficient that tax is** - this is commonly referred to as "**tax neutrality**"
- With respect to the 2nd measure of efficiency, a **simple tax is more efficient than a complicated tax** because it costs less for taxpayers to comply with and less for the government to verify compliance
- The more certain a tax is, the less costly it is to comply with (from the taxpayer's perspective) and administer (from the government's perspective) - and hence is more efficient
- Often in practice, tax is used to "modify/influence" taxpayers behaviour (ie. tuition tax credit, RRSP's, TFSA, carbon tax)

Fairness of Equity:

- **Basic Principle:** Canadians will more likely (ie. "voluntarily") comply with our tax legislation if they view it as being fair and equitable
    - **IMPORTANT**: of course, what is fair/equitable is highly personal and contextual. Almost all of the great legal philosophers have their own theory of what is fair/equitable
    - Depending on which theory you identify with, you will prefer particular types of taxes which are consistent with the theory
- **Horizontal Equity:** similarly situated taxpayers should be treated/taxed the "same"
    - Example: Cassie and Julia each make $100,000 of pre-tax income. They each pay $25,000 of taxes
    - Could this result ever be viewed as **not being fair/equitable?**
        - Answer: if someone has significantly more non-discretionary (ie. medical) expenses
    - Generally speaking if you are someone who provided services to someone else for compensation, for tax purposes that compensation will be characterized as business income or employment income
        - Choice b/t employment and business, if you are the taxpayer you would rather it be categorized as business revenue instead of employment
- **Vertical Equity**: higher income taxpayers should pay more tax than lower income taxpayers
    - Is this fair/equitable?
        - Answer: in an income tax context, this has been justified primarily on the basis that as you earn more income, more of that income is available for such things as taxes and discretionary expenses (commonly referred to as the **"ability to pay" principle**)
        - In contrast, lower income persons must use all or substantially all of their income to survive - and hence do not have any "extra" to contribute to society (in the form of taxes or otherwise) - which justifies them having a lower (or no) tax burden/rate
    - Note: while this justification is generally accepted as justifying income taxes, it does not necessarily prescribe how much more (or less) particular taxpayers should pay
- While taxes (and tax regimes) can be evaluated on these, and other measures, it is important to appreciate that often, the values underlying these measures can conflict with one another and as such, have to be ranked

    - For instance, if **simplicity** is the more important goal of our tax system, then we (usually) need to be prepared to tolerate some **unfairness**; conversely, if the more important goal is **fairness**, then we will likely (but of course not always) have a **more complicated** regime.

<u>**Tax Expenditures**</u>

- In addition to raising revenues, countries (including Canada) typically use their income regime to provide benefits (in the form of credits, deductions or exemptions) to some (or all) of its constituents. These are commonly referred to as "tax expenditures".
    - They are called "tax expenditures" b/c they cost the government money, normally in forgone taxes as opposed to raising money
- Generally speaking, these programs could be administered outside of the income tax regime as a separate "spending program"
    - For instance, the Federal (and/or provincial) government could pay each post-secondary student $1,000; however, our current regime is to give such students (or in some cases, their spouse/partner/parent) a tax credit
- Questions:

1. **What are some examples of tax expenditures in our Act?**
    a. Tuition Tax Credit
    b. Medical expense tax credits
    c. Principal residence exemption - gives Canadian taxpayers the ability not to pay tax on any gains on their home
    d. Childcare benefits
2. **Why are they administered through the Act, rather than as a separate regime?**
    a. Already have this mechanism to have people report their financial information and there is already an adminitor in place to verify (infrastructure is already in place). So why not make it a two way street and have things flowing both ways
    b. Rather than having taxpayers transfer money to the gov't and then have the gov't transfer money back to individuals, why not just have it net against each other and the taxpayer either pays less or the gov't sends out a check.
    c. Encourages people who are eligible for these tax expenditures to file their tax returns in a timely and complete matter and apply for the assistance
3. **How do we evaluate tax expenditures?**
    a. Answer: Possible measures/questions could include:
        i. What is the government hoping to accomplish with this tax expenditure?
        ii. Do the expenditures actually benefit the intended recipients?
        iii. How much does it cost to administer this expenditure (both from the taxpayer's and the government's perspective)?
        iv. Do they actually motivate intended types of behaviour (where the intention is to motivate behaviour) (ie. did the Children Fitness Tax Credit actually result in more physically active and healthy children)?
        v. Are the benefit allocations fair/equitable?
    b. Revenue generation is not an appropriate or helpful element to evaluate a tax expenditure

- Each year the government creates a Tax Expenditure Report which quantifies the cost (in terms of lost tax revenues) of all tax expenditures

History of Income Taxes in Canada

- While incomes taxes are an extremely important tax and revenue source in Canada today, this has not always been the case
  - The first federal income tax legislation, the *Income Tax War Act*, was enacted in 1917 as a "temporary tax" to finance Canada's participation in WWI
  - Prior to this, the federal government relied primarily on symptoms duties and excise taxes and the province/municipalities relied on property sales and property taxes
- In 1948 (31 years after it was enacted), Parliament decided to make the "temporary" *Income Tax War Act* into a new "permanent" *Income Tax Act* (and hence dropped "war" from the title)
- In 1962, Prime Minister John Diefenbaker created the Royal Commission on Taxation, which was chaired by Kenneth Carter, a prominent tax accountant, to review, analyze and make recommendations on all aspects of Canadian Federal taxation. In 1967, the Commission released a six volume report which was viewed around the world as a great contribution to tax knowledge and analysis
- After studying this report and issuing a White Paper suggesting possible changes, Parliament implemented several significant amendments to the Act effective January 1, 1972. It included the following three fundamental changes to Canadian income taxation:
  - It **broadened the tax base** (ie. what is subject to tax) - most notably, by making the gains (and losses) from the disposition of capital property taxable
  - It **reduced the taxation rates and the number of tax brackets**
  - It **integrated the taxation of corporations and their shareholders**
- In 1987, the Federal (Conservative) government introduced a White Paper, which proposed to (among other things):
  - **Convert many personal deductions into credits**
  - **Enact a "general anti-avoidance rule" to prevent inappropriate/abusive tax planning**
  - **Introduce a new Goods and Service Tax (GST) to replace the existing Federal Sales Tax**
- More recently, the current (Liberal) Federal Government has changed the Act to significantly reduce the ability to use a private corporation to "split income" among family members and increase the family's total after-tax income
- Another interesting piece of history (which continues today) is Canada's practice of having a federal organization (currently the Canada Revenue Agency) administer and collect not only federal, but provincial income taxes
  - This is accomplished through "tax collection agreements" which generally require the provinces to use the *Income Tax Act's* calculation of "**taxable income**"
  - For this reason, most provincial income tax legislation is very short (particularly compare to the *Income Tax Act*)
  - Two main exceptions are **Quebec income taxes** (both personal and corporate) and **Alberta corporate income taxes** - both or which are administered by the respective provinces
- While we have tax reforms over the years, we haven't had a **Royal Commission** like in 1962 that's looked at all aspects of our tax regimes Federal and Provincially, and many tax practitioners have been calling for an assessment to this extreme to happen again.
  - This is b/c there has been so many changes made to the tax regime but when you look at the tax regime as a whole, it may not make sense anymore and need adjustments
  - Likely not going to happen anytime soon especially since COVID-19 but maybe in the next 10 years

Capital Gains

- Arises from the disposition of capital property
- First ended to characterize property, and then we need to disposition of that property
- Two types of property: capital property, and business property
- No test in legislation need to look at case law. Primary and secondary test
- 248(1) - definition of property
- If a taxpayer acquires property and the primary intention for acquiring is to use the property it will be characterized as capital property

What it means to tax a capital gain

Questions from Unit 1 Quiz:

1. An individual in Alberta files his/her Federal income tax return with the CRA and his/her Alberta income tax return with Alberta Treasury.
    a. True or **False**
2. Which of the following provincial taxes, if any, would be unconstitutional?
    a. A sales tax which is levied on consumers and which is collected by the retailers on the gov’ts behalf
    b. **A liquor tax imposed only on restaurants and bars, who are expected to include this tax in their price to their customers**
        i. This is unconstitutional b/c it constitutes an “indirect tax” (ie. imposed on one person - the restaurant/bar - with the intention that this person then recover the tax from another person - the customer/client of the restaurant/bar). Under s. 92(2), provinces only have the power to enact direct taxes
    c. An income tax levied on individuals resident in Alberta

UNIT #2 - SOURCES OF INCOME TAX LAW

The Income Tax Act

- As we all know, the primary source of income tax law in Canada is the ***Income Tax Act,*** RSC 1985, c1 (5th Supp)(Act), as amended
- While each commercial publication of the ITA is slightly different, they all generally contain the following:
    - **Table of Proposed Amendments**: which shows the status of budgetary amendments
        - Used to get an idea of draft legislation that may not be enacted as intended or at least not using the normal procedure
        - Helpful to see where legislation has been proposed in a previous year but hasn’t smoothly gone through the process of becoming law; question of whether it will ever become law; whether the gov’t is going to make changes; whether the draft legislation will be withdrawn → good place to start looking for this info
    - **Tax Reference Tables:** which are very useful for quick reference of tax rates, credits, etc.
    - **Detailed Table of Sections:** which can be useful research starting point

    - **Legislative Provisions:** well each publication differs slightly in form and in content, for each section of the Act, in addition to the actual provision, there will be a **Related Provisions** and **Notes** section
- **Index:** along with the **Detailed Table of Sections,** this part of the ITA can be your best friend - often a starting point for research of the legislation - look for key terms and go from there

Income Tax Application Rules (ITARs)

- As previously noted, there are **five sources of income that are taxable** under our current Act, namely: employment income, business income, property (investment) income, net capital gains/losses, and other income (RRSP, Spousal payments, etc.).
- **Prior to 1972, capital gains and losses were not taxable;** they were outside the scope of the Act
    - Conversely, **business profits have always been taxable** in Canada
    - So prior to 1972, when a taxpayer realized a gain from the disposition of property, the taxpayer typically wanted the gain to be characterized as a capital gain - so the gain would not have to be included in income and no taxes would have to be payable
- Effective January 1, 1972, the gov't decided to make capital gains and losses taxable (on the recommendation of the Royal Commission on Taxation)
- To ensure that gains in the value of capital property that occurred prior to 1972 were not now taxable as a result of this major change to our tax regime*, the Act was additionally amended to include these ITARs
    - *this is commonly referred to as a "retroactive tax amendment" - it effectively has application prior to its announcement/enactment. While technically, gov'ts have the power to make retroactive tax amendments, as they are generally frowned upon, it does not happen often.
    - Generally speaking, the purposes of the ITARs is to reasonably make sure that only gains in value post-1971 are taxable
    - Put another way, the ITARs generally ensure that this is a prospective tax policy change, rather than effectively being retroactive
    - This is accomplished by setting out rules on how to calculate the "tax cost" of capital assets which were acquired prior to 1972 in order to be able to calculate the asset's post-1971 gains
        - In the case of publicly-traded securities, this is very easy - the gov't recorded the ending trade values for all publicly-traded stock on December 22, 1971 (i.e. the last "trading day" in 1971) - this is the "tax cost" for calculating post-1971 gains*
            - *para 24(1) of the ITARs
            - **EX:** Dianne purchased 100 shares in Hudson's Bay company in 1960 for $1/share ($100 total). On December 31, 1971, these shares were trading at $5/share. She sold them on September 15, 2020 for $2000/share ($200,000 total)
                - As a result of the ITARs, Dianne gets to use a tax cost of $5/share rather than $1/share - reducing her capital gain and saving her the associated tax
        - In other cases (where the asset was not publicly valued on December 31, 1971 - such as farmland), the ITARs set out how to calculate the January 1, 1972 "tax cost" - generally, as the amount that is neither the greatest nor the least of (a) the (original) cost of the property to the taxpayer, (b) its fair market value on December 31, 1971, and (c) the taxpayer's proceeds of disposition of the property.
- Obviously, with the passage of time, the importance of the ITARs have declined to most taxpayers (i.e. capital assets will have been acquired after January 1, 1972 and hence this is not an issue)
- Purpose of ITARs - determine appropriate cost for the purposes of calculating post 1971 gain on the sale of capital assets

Notes:

- Not publicly traded shares - Farmland (most common in 1971) how do we deal with this?
  - Rule that allows families to transfer their farm (qualified farm property) down through generations without triggering taxes → provisions are called **“Roll overs”**
  - Lifetime capital gains deduction (can only be used for very specific property)→ “qualified farm property” is one of these items and it can be sheltered up to $1M of capital gains
- Gains and losses have to be calculated when a taxpayer actually disposes of capital property. It also applies where a taxpayer is <u>deemed to dispose</u> of capital property
- **Deemed disposition** - most common is when someone dies (**s.70** - general rule, when a taxpayer dies, he/she is deemed to dispose of all capital property immediately prior to death in order to trigger the calculation of the gains/losses so they can be taxed in the decreased taxpayers terminal tax return
- ITARs are still relevant mainly with real estate, not uncommon for someone to have owned the property prior to 1971 (especially someone who has passed away)

<u>Income Tax Regulations</u>

- As discussed in unit #1, Parliament and the provincial/territorial legislatures have the ability to delegate its ability to enact taxation (and other) law
  - One of the primary benefits of delegating the law-making power, typically to the Executive Branch of gov’t, is its speed/efficiency - Income Tax Regulations do not have to go through the full legislative process
  - Of course, to be valid, as previously discussed, any “subordinate legislation” created by the delegate must be within the scope of the delegated authority
- **Para 221(a)** provides that the Governor in Council may make regulations “prescribing anything that, by this Act, is to be prescribed or is to be determined or regulated by regulation”
  - Some of the more common/popular Regulations are those that specify the rates of depreciation for certain capital assets for tax purposes, and the tax-free mileage allowance that an employer can pay to an employee for “work trips” - which in somes cases are adjusted/updated on a yearly basis

<u>Tax Treaties</u>

- Canada levies income taxes in two situations:
  - 1) On **persons** who have a **close connection** to Canada - specially, where such persons are **“residents”** of Canada
    - Where Canada taxes a Canadian resident, it taxes the residents **worldwide income**
  - 2) on **income** that has its **source** within Canada
    - Given Canada’s first basis of taxation (the taxation of Canadian residents’ worldwide income), **source taxation applies** where the person earning the Canadian-sourced income is a **non-resident of Canada**
    - Under this second basis of taxation, **Canada will only tax this Canadian-source income** (as opposed to the worldwide income of a Canadian resident)
- Most countries levy income taxes based on similar connections (connections with the person and/or with the person’s income)
- As a result, it is not uncommon for a person to be subject to “double tax” on some (or all) of his/her income (i.e. subject to tax in Canada b/c person is a Canadian resident; subject to tax in the United States since the income is earned there)
- To alleviate this double-tax problem, bi-lateral tax treaties exist. These treaties effectively override a country’s domestic tax legislation in certain specified situations

- While the elimination of double-tax was the initial motivation for the creation of bi-lateral tax treaties, tax treaties are also used (especially more recently) to:
  - Assist in the mutual enforcement of each country's tax legislation
  - Share tax information
- **Note:** a person seeking treaty relief must be eligible for it and generally must elect for the treaty to apply

<u>Persons Involved in the Creation and Administration of Income Tax Law</u>

- There are 4 key players involved in the creation and administration of income tax law in Canada"
  - **(1) The Department of Finance**: who makes key tax policy decisions (of course, with input from the Prime Minister's Office and Cabinet) and drafts the associated tax legislation
  - **(2) The Department of National Revenue:** who administers the Act through the Canada Revenue Agency (CRA)
  - **(3) The Department of Justice:** who represents the Minister of National Revenue/CRA in court
  - **(4) The Court System:** who interprets/applies the legislation as well as supplements such legislation through its common law decisions
- **Important Point**: technically speaking, the CRA **does not make the law**, it enforces it (and must comply with it just as all taxpayers must comply with it)

<u>The Legislative Process</u>

- Generally speaking, the enactment of ner (federal) tax legislation typically begins with the Minister of Finance delivering the gov'ts Budge in the House of Commons
- Typically, Budget preparations are done outside of the public sphere such that, on Budget Day, there is some uncertainty as to what the gov't is proposing to do
  - **Why?**
    - Trying to avoid changing/influencing taxpayers behaviour, if changes were announced prior to the Budget, people may try to defer tax or increase tax to take advantage of changes.
- At the time the Budget is announced (or soon thereafter), the govt't releases a Notice of Ways and Means Motion to amend the Act, which is generally drafted using "ordinary language", as well as a draft of the proposed legislative changes, accompanied by Explanatory or Technical Notes intended to explain the purpose of each amendment
  - Note: in practice, these Explanatory/Technical Notes are extremely valuable to taxpayers, tax practitioners and judges - as they give some/more insight into what the gov't was concerned about and trying to accomplish with the new legislation
    - Of course whether the gov't was successful in realizing its intention is ultimately determined by the courts
- Following the delivery of the Budget, there is a debate (on it) in the House of Commons
- Sometimes after the delivery of the Budget (and the associated debate), the gov't will introduce a Bill in the House of Commons to implement the proposals set out in the Notice of Ways and Means Motion
  - Like other federal bills, it will go through three readings in the House, be debated and refined and sent to Parliamentary subcommittees, and be similarly reviewed by the Senate, before receiving Royal Assent
- While the bill becomes law upon receiving Royal Assent, the general Canadian practice (unless an alternative implementation date is included in the draft legislation) is that at the time of Royal Assent, the legislative amendments become **effective retroactive to the Budget date** when they first announced
  - **Why?**

- These legislative amendments are shown in the commercial publications of the Act by shading - and are generally followed as if they were law by taxpayers and tax practitioners
- **Question:** What if there is a change in gov't b/t Budget day and Royal Asset? Could the change in gov't result in proposed legislative amendments **not** get passed (or at least not in their published form) - causing problems for taxpayers who followed them on the assumption (and general practice) that they would become law?
    - **Answer:** to no ones knowledge has a new gov't ever failed to pass the legislation of its predecessor gov't. Whoever forms the new government, still passes the old government's legislation even if they are opposed to it if it is in the middle of the process. → if they are opposed, they can propose and bring out their own legislation to change the rule back immediately once in power

<u>**Tax Cases**</u>

- The primary court of first instance for tax cases today is typically the **Tax Court of Canada**, which was created by the *Tax Court of Canada Act* (T-2) in 1983
    - It has "exclusive original jurisdiction" to hear appeals with respect to various matters and statutes including, for our purposes, the *Income Tax Act* **(S.12)**
- **Important Point:** not all tax matters come before the Tax Court as the court of first instances (so you may have to look to decisions from other courts depending on the issue). For example:
    - **Criminal Matters** (such as tax evasion) will be heard either in **Provincial Court** or **Court of Queen's Bench** depending on the type of offence (summary conviction or indictment) and available election
    - **Applications for judicial review in respect of CRA decisions** where the Act gives CRA discretionary decision-making powers (ie. power to waive interest and penalties on outstanding assessments) - these must be done in **Federal Court**
    - **Applications in respect of the CRA's use of its audit and investigatory powers** under the ITA (ie. search and seizures, requests for information by 3rd parties, etc.) - again, must be done in **Federal Court or a superior court in the province**
    - **Appeals from CA decisions with respect to the registration and deregistration of charities, pension plans** and other entities under the ITA - appeals must be initiated at the **Federal Court of Appeal** (without first having a hearing before a trial judge)
    - **Determinations of residency for provincial/territorial tax purposes** are done in the **Court of Queens Bench** of the relevant/seeking province/territory unless the relevant provincial/territorial ITA specifically gives the Tax Court the power (which to my knowledge, no province/territory has)
- **Section 20** provides that the Tax Court has the ability to make its own rules of Court (which it has - so make sure you consult it as the rules might be different than the Rules of Court within the province)
- The Tax Court is a **national court** that hears cases throughout the country
- There are two types of hearings in the Tax Court - **general** and **informal procedure** cases
    - **General Procedure (GP)** cases have all the trappings of a QB case including examinations for discovery/documents*, expert witnesses, full precedential value, cost awards, appeal rights, etc.
        - *per subsection 17.3(1), the right to an oral examination for discovery may be restricted if the amount in issue is $50,000 or less
        - Note: only lawyer or the taxpayer themself can run a GP case - **section 17.1**
        - Currently there is no special "tax bar" - any lawyer is able to appear before the Tax Court - **ss 17.1(2)**
        - If you anticipate that you are not going to win at the tax court and foresee that you will have to appeal, then you might want to proceed through GP

- **Informal Procedure (IP)** cases are more stream-lined and intended to be faster, less costly and more accessible to the general public (intended to be analogous to Small Claims Court)
  - These cases do not follow the full litigation procedure, strictly speaking, are not bound by the rules of evidence*, do not have a general right of appeal (generally speaking, confined to "judicial review"), no full schedule of costs and, have no precedential value **(s. 18.28)**
    - * that said, in every presentation that I have heard from a Tax Court Justice, they have stated (not surprisingly) that they will still be looking for evidential safeguards (particularly when evidence is being provided by a taxpayer or a taxpayer's witness)
    - **Important Point:** Practically speaking, the decisions have precedential value
  - For income tax cases, to qualify for informal procedure, **amount of federal tax and penalties in dispute for each taxation year, excluding interest, must be $25,000 or less** - see s.18
  - If more than $25,000, then can elect to dispute only $25,000 (give up on and pay the rest)
  - **Note:** can have someone other than a lawyer or the taxpayer themselves fun the case (ie. accountant, husband/wife, etc,)

- Appeals from the the Tax Court are to the Federal Court of Appeal and then to the Supreme Court of Canada (by leave of the Court)

<u>Canada Revenue Agency Publications</u>

- To assist taxpayers (and tax practitioners) in complying with the Act, the CRA issues a variety of different publications. Some of the more common and comprehensive ones are:
  - **Income Tax Folios:** these publications are currently being issued to replace **Interpretation Bulletins.** Both Folios and Interpretation Bulletins are intended to provide taxpayers (and tax practitioners) with **summaries of the law** and the **CRA's interpretation of the law** (where the law is uncertain) on a subject-area basis
    - <u>Important Point:</u> neither the summaries not eh CRA's interpretations (neither of which are labelled as such) are binding upon the CRA nor should they be blindly relied upon by taxpayers (and tax practitioners) as reflecting the current law (or even the CRA's current administrative/interpretative policy)
    - That said, where taxpayers have relied upon the CRA advice, if it turns out the taxpayer has an outstanding tax liability (when the correct law is applied), the cour will typically direct the CRA to waive any associated interest (and penalties), if assessed
    - Provide information on the substance of the law
  - **Information Circulars:** these publications generally provide information on **how to comply** with the Act (ie. how to do a "fairness application") rather than summaries and interpretations of substantive tax law
  - **Advance Tax Rulings:** are, as the name indicates, ruling given by the CRA (Income Tax Rulings Directorate) on a **proposed** (as possessed to completed) series of transactions as to what they believe the tax effects will be
    - The stated purpose of a ruling "is to promote voluntary compliance, uniformity and self-assessment by providing certainty with respect to the application of Canadian income tax law to proposed transactions"
    - To obtain such a ruling, a taxpayer and her advisors must furnish the CRA with complete a disclosure of the facts or transactions contemplated along with a cheque for services to be rendered

        - The CRA states that it will abide by its advanced income tax rulings subject to any qualifications stated in the ruling
        - However, when there is a material omission or misrepresentation in the statement of relevant facts or the proposed transactions submitted by the taxpayer or the taxpayers authorized representative, the advanced income tax ruling will be considered invalid and the CRA will not be bound by it
            - Further, if the law changes prior to the transactions being fully completed/implemented, then the ATR will similarly not apply
    - To assist other taxpayers, they are published by commercial tax publishers such as Carswell and CCH (after taxpayers specific information is removed)
    - Note: strictly speaking, the CRA is under no obligation to issue an advanced income tax ruling and can (does) refuse to issue one if it doesn't want to
        - It has stated that it generally will not issue a ruling where the request concerns "**primarily a factual or legal determination**" (ie. residence, income vs capital, or carrying on business)*
        - It has similarly stated that it generally will not issue a ruling "confirming the application of provision that is conditional on the existence of facts (including an intention), especially where the facts or intentions have to be inferred from the circumstances"
    - The CRA is also willing to do a "pre-ruling consultation" to discuss a particular (usually novel) tax issue to determine whether the taxpayer should submit a ruling request
- **Technical Interpretations:** these are similar to ATRs in that you are asking the CRA for their interpretation/position. However, these interpretations generally:
    - Are a particular provision rather than to proposed transaction
    - Are done on a "no-names" basis (as opposed to full disclosure)
    - Are not subject to any fees from the CRA, and
    - The CRA is not bound by the Technical Interpretation (although they likely would follow it - it would also have value in defending against possible gross negligence penalties)

UNIT #3 - WHO IS SUBJECT TO TAX?

General Requirements

- Subsection **2(1)** provides that **"every person resident in Canada at any time in the year"** will be subject to Canadian income tax on their "taxable income".
- This means that all of your taxable income to be subject to anadian income tax, you must:
    - 1st - be a **"person"**, and
    - 2nd - be a **"resident in Canada"**
- **Question:** What if you are not a "person" for Canadian income tax purposes?
    - Generally speaking, you are not subject to Canadian income tax
    - Note: as we will later see, this is not a theoretical point - there are common Canadian entities that do not constitute persons for tax purposes
- **Question:** what if you are a "person" for income tax purposes, but not "resident in Canada"?
    - All of your taxable income **will not** be subject to Canadian income tax
    - **But:** pursuant to **subsection 2(3)** (supplemented by section 115) and **section 212** (and subsequent sections in Part XIII), certain income that can be source to Canada will be subject to Canadian income tax (unless eliminated by an applicable tax treaty)

<u>A Brief Overview of the Canadian Taxation of Non-Residents</u>

- How Canada imposes income tax on persons who are non-residents of Canada. Two main parts of the act that can potentially be engaged (two parts deal with different kinds of income). Canada will seek to levy tax based on one of two connections to the country:
    - (1) sufficiently strong connection b/t the person and the country
        - Connection Canada uses b/t itself and a person is this concept of "residency" if they are a resident in Canada they will be subject to taxes on their worldwide income in Canada
        - Broader connection and broader tax consequences
    - (2) not a resident of Canada (non-resident)
        - Canada will still seek to impose income tax but focus is on the income earned by the income rather than the person itself. Where it can be said that the **income** has a strong connection to Canada, this will be taxed
- **Subsection 2(3)** provides that where a person who is not taxable under **ss 2(1)** (ie. a non-resident of Canada):
    - Was employed in Canada
    - Carried on business in Canada, or
    - Disposed of a "taxable Canadian property"
        - **"Taxable Canadian property"** is extensively defined in **subsection 248(1)** to include a variety of items including: real property situated in Canada, property used in carrying on a business in Canada, shares of a privately held corporation (and interest in partnership or trust) where more than 50% of the value can be attributed to certain types of property located in Canada (ie. real property), shares of a publicly-traded corporation (where certain similar characteristics are met), etc.
    - *beyond the scope - but there there is a treaty, it may prevent land tax
    - Then the income/gains from those activities, **but only those activities**, will be subject to Canadian income tax (under Part I of the Act);
- In addition to non-residents being subject to tax under Part 1 of the Act (ie. subsection 2(3)) on certain types of income sourced to Canada, the Act provides for taxation of other Canadian source income in Part XIII.
- More specifically, **section 212** lists several types of (passive) income (management fees, interest, rents, royalties, pension benefits, dividends, etc.) that will be subject to a special "withholding tax" of 25% under **Part XIII** of the Act (unless reduced/eliminated by tax treaty) on the **gross amount paid** to the non-resident
    - With countries that Canada has a tax treaty with, the 25% can be reduced
- **Caution:** while a detailed discussion of the taxation of non-residents is beyond the scope of this course, it is very important to be alert for situations where a non-resident is involved - not only if you are acting for a non-resident (to ensure that the non-resident complies with their applicable Canadian tax responsibilities), but additional if you (or your client) are dealing with a non-resident.

Example: Acquiring Canadian Real Estate from a Non-Resident (Section 116)

- As noted above, pursuant to **paragraph 2(3)(c)**, if a **non-resident disposes** of **Canadian real estate** (which constitutes "taxable Canadian property" under **subsection 248(1)**), then the **non-resident may be taxable in Canada on the gain/loss** from the disposition (if any).*
    - *we will discuss taxation of dispositions of capital property in more detail in a subsequent unit. For our purposes at this stage, it is sufficient to note that when there is a disposition of capital property (ie. property acquired by the taxpayer to use it - as opposed to sell it for a profit), the taxpayer is required to calculate the gain or loss and include the taxpayer portion (ie. 50%) in his/her tax return - with certain exceptions/modifications in particular cases

- **"Disposition"** is defined in significant detail in **subsection 248(1)** to include a variety of transactions including:*
    - Any transaction or event entitling a taxpayer to proceeds of disposition (ie. a "sale"), and
    - A gift
    - Note: not all transfers of taxable Canadian property will require full compliance with **section 116** as described in this section - but the details of the modifications/exceptions are beyond the scope of this course
    - *as an **"inclusive"** definition, it does not preclude the application of the **ordinary dictionary meanings** of "disposition"
- Note: no "gift tax" in canada but we have this **disposition** and if the gift is capital property and at the time of the gift the fair value is in excess of the "tax cost" (adjusted cost base (ACB)) then possible tax.
    - **No income tax implication to the recipient of the gift, BUT possible tax implications to the donor of the gift**
- **Issue:** given that the owner is a non-resident, Canada is (rightfully) concerned that it will be able to collect its tax on a disposition of taxable Canadian property by a non-resident person in a cost-effective manner
- To address this issue/concern, **section 116** provides **two ways** that a non-resident owner of taxable Canadian property can comply with the Act (ie. no penalties or other "enforcement" action by the CRA):
    - **Method 1:** the non-resident can comply with the requirements of **s. 116 prior to the transfer of property occurring.** This requires the non-resident taxpayer to do two things:
        - (1) give the Minister **advance notice** of the disposition pursuant to subsection 116(1) by providing **relevant details of the disposition**, namely: name and address of the proposed purchaser, description of the taxable Canaidan property, the estimated proceeds of disposition, and adjusted cost base of the property, and
            - **Important Point:** while paragraph 116(1)(a) refers to "the name and address of the person to whom he [the non-resident] proposes to dispose of the property", which it then defines for purposes of s.116 as the "proposed purchaser"
            - This wording **should not be interpreted as meaning that if the non-resident gifts the taxable Canadina property, s.116 does not apply. It does apply to gifts!**
        - (2) provide a **prepayment/deposit** (or furnishes adequate security) of the associated Canadian income tax as calculated under **subsection 116(2)**
            - Adequate security - set up a line of credit at a bank that the CRA can draw upon at any time with no restrictions
        - Where the non-resident (or his/her advisor) does this timely (ie. prior to the transfer), correctly, and accurately, then the CRA will **issue to the non-resident and the proposed purchaser a "Section 116 Certificate"** which allows the transfer to occur with no potentially detrimental tax consequences to the purchaser (and no need for the purchaser to take any steps to protect themselves - as discussed below).*
            - This is the preferred approach (particularly from the purchaser's perspective
            - *as a result of Covid-19, processing times for the issuance of a s.116 Certificate have increased. In a communication released by the CRA on June 26, 2020, the CRA has stated that this has effectively resulted in the purchaser having to withhold and remit a portion of the purchase price as described under method #2.
            - Assuming the transaction proceeds in the manner described in the disclosure

    - **Method 2:** if a non-resident does not follow the procedures under Method 1, the **subsection 116(3) requires the non-resident to provide the Minister with the relevant details of the disposition (as described above) within 10 days of the disposition** to avoid the imposition of penalties against the non-resident*

        - *one of the possible penalties is contained in **subsection 162(7)**, which provides a penalty of the greater of $100 and $25 multiplied by the number of days outstanding (up to a maximum of 100 days). Of course, this penalty is in addition to the requirement on the purchaser to remit 25% of the purchase price in a timely fashion.
        - **S.116(4)** provides where in addition to this timely disclosure, the non-resident provides a payment (or furnishes) adequate security, the Minister will issue a S.116 Clearance Certificate to both the non-resident vendor and the purchaser (as described above)
        - **Important Point: subsection 116(5)** provides that subject to a few exceptions (one of which we will discuss below):
            - Where a purchaser obtains taxable Canadina property from a non-resident,
            - But does not possess a valid s.116 Certificate at the time of acquisition,
            - The purchaser is **liable to pay and remit** within 30 days after the end of the month in which the purchaser acquired the property **25% of the purchase price***
                - *if the non-resident gifts the property, then the recipient may be liable to remit to the Receiver General 25% of the fair market value (FMV) of the property on the non-resident donor's behalf
            - The purchaser is entitled to withhold this amount from the agreed purchase price to the non-resident vendor
- **Notes: Practical Consequences and the appropriate tax strategy**
    - (1) when you are drafting a contract for the disposition of property (for sale or git of a non-resident) in particular to a sale you want to put in the contract a specific provision that says:
        - If the purchaser doesn't have a valid s.116 certificate prior to the transfer date, then the purchaser under the contract is permitted to withhold and remit 25% of the purchase price and send it to the Receiver General
    - **(2) Exception:** as an alternative to having a valid s.116 Certificate, another way that the purchaser can avoid having to comply with subsection 116(5) is if "after reasonable inquiry, the purchaser had no reason to believe that the non-resident person was not resident in Canada" (Reasonable Inquiry Test)*
            - ***subsection 116(5.01)** provides some additional relief to the purchaser in respect of "treaty-protected property" (beyond the scope of this course)
            - **Important Point:** this "reasonable inquiry" safeguard must be done **diligently** and not causally/blindly
            - In *Kau*, the purchaser relied solely on the standard warranty/representation in the real estate purchase agreement that the vendor was not a non-resident **at the time of the transfer**, despite the purchaser and his lawyer being aware of several other facts that suggested that the vendor **was a non-resident**
                - Note: absent the existence of such facts, the CRA's general view is that a statutory declaration sworn by the vendor that he/she is not a non-resident will generally be accepted as satisfying the Reasonable Inquiry Test
            - Given these facts, Justice Russell held that the purchaser had not satisfied the reasonable inquiry test - and hence was required to pay 25% of the purchase price to the Receiver General in respect of the (California) vendor's Canadian tax liability

- Note: for timing, at the time of transfer is the vendor a non-resident?

- **Question:** what if the purchaser pays the full purchase price to the vendor without knowing that the vendor is a non-resident and s.116 is applicable - and then is additionally required to pay 25% of the purchase price to the Receiver General pursuant to s.116(5)?

- Answer: of course, the purchaser can try to recover the additional payment from the non-resident vendor*
    - * the challenge is that the non-resident (by definition) is outside Canada so it may be difficult and costly to successfully recover the monies from the seller/donor (which is why Canada has enacted s.116)
    - Alternatively/additionally, the purchaser appears to be able to sue their legal advisor for not property protecting the purchaser - as was successfully done in *Mao v Liu* (2017 BCSC)*
      - **Mao* involved the purchase of real estate in Vancouver for %5.56 million. The sale actually occurred with a creditor of the registered owners (CEIR) pursuant to a court order. The purchasers (Mao) had hired a notary public (Tony Liu) to represent them in conveying the title of the property to them and had specifically detailed in their engagement letter that the notary "make inquiries as to the residency status" of the owners as required by the Act. While the notary did make inquiries about the owners' residency status with the creditor's legal counsel BLG LLP (which BLG never answered) as well as tried to get BLG to complete a statutory declaration that the owners were Canadian residents (which BLG refused to complete), the Court found that these steps were not sufficient to satisfy the "reasonable inquiry" safe harbour set out in s.116(5). As one of the owners was a non-resident of Canada, the CRA assessed the purchasers for $695,000 in respect of this transaction. In this case, Justice Affleck granted the purchasers' application for summary judgment of $685,000 (plus costs) against the notary

- **Summary:** to protect the new owner from having to pay 25% of the purchase price to the Receiver General after having paid 100% of the purchase price to the non-resident vendor (and to protect the legal advisor from being sued for this amount), they should withhold 25% of the purchase price where he/she does not receive a certificate from the vendor prior to the sale closing and remit it to the Receiver General.*
  - * while I believe that this should be clearly specified in the contract, regardless, **s.227(1)** provides that "[n]o action lies against any person for deducting or withholding any sum of money in compliance or intended compliance with this Act".

<u>Other Payments to a Non-Resident</u>

- **Important:** where a **Canadian resident** is making certain kinds of payments to a non-resident (ie. interest, dividends, retnts, etc.)that are taxable in Canada pursuant to **s.212** (nd Part XIII more generally), the Canadian resident may be required to **withhold and remit an amount** in respect of the non-resident Canadian taxes payable pursuant to **s.115***
  - *details are beyond the scope of this course, but the non-resident has the option under s.216 to elect to file a Canadian tax return in respect of the non-resident rental income (of real property) and timber royalties. Where the non-resident makes this election and files a Canadian tax return, generally speaking, the Canadian resident renter is then relieved from making source withholdings and remittances in respect of the rental payments.
  - Analogous to the effects provided under s.116, if the Canadian resident payor does not make such withholdings and remittances, then Canadian resident payor becomes personally liable for the amount pursuant to s. 215(6) - and then must try to recover the amount from the non-resident

<u>Who is a "Person" for Income Tax Purposes?</u>

- As noted above, s.2(1) provides that "every **person** resident in Canada…" is subject to Canadian income tax. So what is a "person" for tax purposes?
  - This is a question of statutory interpretation - and to my knowledge, the proper approach is to first see if the legislation (or the case law) has a special definition of the word (or phrase) for purposes of the legislation. If not, then the general rules is that the ordinary dictionary definition applies
- For Canadian income tax purposes, the first place to look to see if there is a special definition is **s.248(1).*** Looking at the definition of a "person" in s.248(1), we know that:

    - It is (another) **“inclusive definition”** - meaning that it doesn’t define person completely (and hence you can/should consider the ordinary dictionary meanings as well)
    - It includes a **corporation**
    - It also includes **tax exempt entities** as defined in **s.149(1)**
        - Ie. gov't organizations; charities
        - Although exempt, still need to file a tax return - if they don’t they risk potential penalties for non-compliance
    - It also includes both ***inter vivos* and testamentary trusts** (last part of the definition)
        - Includes corporations, trusts, etc.
    - * In addition to the definitions contained in s.248(1) which generally apply to the entire Act, there are other definition sections (ie. sections 54 and 125(7)) which apply for more limited purposes (ie. the calculation of capital gains/losses and Canadian private corporations)

- **Question:** is an individual a “person” for tax purposes?
    - Answer: “person”, or any word or expression descriptive of a person, includes any corporation, and any entity exempt, because of subsection 149(1), from tax under Part 1 on all or part of the entity’s taxable income and the heirs, executors, liquidators of a succession, administrators or other legal representatives of such a person, according to the law of the part of Canada to which the context extends
        - CRA considers a province to be a person
        - Partnership is not a person for tax purposes and not subject to paying tax (do not need to file tax return) → does not mean they get out of tax (income is notionally allocated to partners in accordance with the partnership agreement (if no agreement then equal distribution) and each partner needs to report their income tax and then pay associated tax)
            - s.96(1) for purpose of calculating the partners income, you begin by treating the partnership as if it was a speaterate person for tax purposes, you calculate the separate income for the partnership and then allocate the income to the partners
            - Note: Certain sections of the act may **deem** a partnership as a person for certain parts of the Act

<u>What does it mean to be a “Resident in Canada” for Canadian Income Tax Purposes?</u>

- Returning (once again) to **s.2(1)**, it provides that for your worldwide income to be subject to Canadian income tax, you must (1) be a **person** and (2) be a **Canadian resident**
- The starting point is the legislation - does it provide a definition/test?
    - Other than the definition of **“ordinarily resident”** in **s.250(3)**, there is no general definition of a “resident” in the Act
    - **S. 250(3)** provides: “In this Act, a reference to a person resident in Canada includes a person who was at the relevant time ordinarily resident in Canada.”
    - **This definition allows a person to be “resident in Canada” in an “extraordinary” year if they are an “ordinarily resident”.**
    - What we do have, for certain persons, are **statutory deeming rules** - which provide that such a person (where the requirements/circumstances are satisfied) will be “deemed” to be a resident for purposes of the Act
- Consequently, to determine whether a person is a resident for Canadian income tax purposes, we have to consider both:
    - The applicable **common law test**, and

- Any applicable **statutory deeming rule**(s).
- **Practice Point:** generally speaking, when a person's residency for income tax purposes is in issue, the person is usually hoping **not to be a Canadian resident** (as that will require them to pay pay Canadain income taxes on their worldwide income)
  - To be sure a person is not a Canadian resident for Canadian income tax purposes, **one must consider both the common law and statutory deeming rules**
- To assist (potential) taxpayers and tax practitioners in answering this very important issue, the CRA has issued Income Tax Folio S5-F1-C1: *Determining an Individual's Residence Status**
  - * while the income Tax Folios do not constitute the law and are not binding on the CRA, these publications can be very helpful. In my opinion, this Folio (which has been revised several times since being issued a couple of years ago) is extremely thorough and helpful → encouraged to read it carefully

<u>**Residence of an Individual - Common Law Test**</u>

- The leading case on when an **individual** will be a Canadian resident for purposes of the Act continues to be ***Thomson v Minister of National Revenue* [1946] C.T.C. 51 (SCC)**
  - Mr Thomson was born in Saint John, New Brunswick and spent the next 5o yeast living and working in Canada. After retiring from his business activities and getting into a property tax dispute, he decided to cease being a Canadian resident and move to Bermuda. While he rented a home in Bermuda and obtained a Bermuda passport, he did not actually spend much time there. Instead, he spent most of his time in North Carolina and New Brunswick, first in rented homes and then in homes that either he or his corporation owned. He was very careful not to stay more than 183 days in Canada per calendar year to avoid application of the "sojourner rule". For the 1940 taxation year, he was assessed as a Canadian resident and hence subject to Canadian income tax on his worldwide income. Mr. Thomson disputed this assessment.
  - As set out in Justice Rand's decision, which is the decision most commonly quotes in subsequent case law (particularly paras 48-50), residence for income tax purposes is:
    - **"Chiefly a matter of the degree to which a person in mind and fact settles into or maintains or centralizes their ordinary mode of living with its accessories of social relations, interest or conveniences at or in the place in question"**
  - In defining when an individual will be resident for income tax purposes, the Supreme Court in *Thomson* (as well as other judges in other cases) also referred to the dictionary definition of "residence", namely:
    - **[t]o dwell permanently or for a considerable time, to have one's settled or usual abode, to live, in or at a particular place.**

  - To assist in understanding this concept of residency for income tax purposes, Justice Rand also distinguished "ordinary resident" from "occasional, causal or deviatory" residence, which is essentially the common law definition of "**sojourning**".
    - **"Ordinarily resident"** was denied by Justice Estey in a concurring decision in *Thomson* as "the place where in the settled routine of his life, he regularly, normally, or customarily lives"
    - As noted above, **s. 250(3)** provides that an individual who is "ordinarily resident" in Canada will generally be a Canadian resident in an "extraordinary year"
    - Conversely, if an individual is only **"occasionally resident"** in Canada in a particular year, then generally speaking **she/he will not be found to be a resident under this common law test** (but may be deemed to be a Canadian resident if he/she is resident for a significant period of the year under the sojourner rule)

- **Practice point:** "ordinarily resident" is an important concept/distinction in Canadian income tax law. Residence for tax purposes inherently requires a level of normalcy, regularity, etc. - **a person won't generally be found to**

be a resident under the common law solely by physically being present in a particular jurisdiction at a moment in time

- To ascertain if an individual is resident in Canada, one must conduct a **comprehensive factual analysis** to see if Justice Rand's definition or residence for tax purposes is satisfied.
  - A case that I like to refer to which outlines/summarizes many of the indicia that a court can and does consider in its comprehensive factual analysis is ***Lee v Minister of National Revenue*** [1990] 1 C.T.C. 2082 (TCC)
- Under this analysis, **the most important/determinative factor is the residential ties of the individual under consideration, their spouse or common law partner and any dependents to Canada.**
  - As noted in para 1.10 of *Folio S5-F1-C1* "while the residence status of an individual can only be determined on a case by case basis after taking into consideration all of the relevant facts, *generally, unless an individual severs all significant residential ties with Canada upon leaving Canada, the individual will continue to be a factual resident of Canada and subject to Canadian tax on his or her worldwide income*.

- **Starting Point:** where is the individual and their spouse/partner/immediate family currently residing?
  - **1st Scenario:** if the individual (whose residency status is in question) is residing in Canada (and this is not extraordinary/unusual), then this is a compelling factor in favour of a finding that the individual is a Canadian resident for tax purposes.
  - **2nd Scenario:** if the individual is residing outside of Canada, but their spouse/partner and/or minor children are residing in Canada, then this is (similarly) a compelling factor in favour of a finding that the individual is a Canadian resident.*
    - *Of course, if the individual in question does not have a spouse, common law partner, and/or minor children, this scenario is not applicable. **Important Point:** only a spouse, partner, and/or minor dependent children are considered in determining the residency of an individual for income tax purposes. The individual's parents and siblings are generally not considered in this analysis.
    - **Question: why would this be the case? Why should someone else's residency situation be relevant to the person in issue?**
      - **Answer:** general presumption that families live together in the ordinary course of living. Assumption that it is temporary/unusual/extraordinary (if it was permanent the family would most likely move as well)
      - It's a presumption it is not determinative, need evidence to rebut
  - **3rd Scenario**: if the individual and their spouse/partner/immediate family are currently living outside of Canada, but they have a dwelling place in Canada available for their use either **immediately** or in a **very short term**, then this will usually be a significant fact in favour of finding the individual to be a Canadian resident.
    - **Question:** why is having a Canadian residence available immediately or in the short-term important in establishing the residency of the owner(s)?
      - **Answer:** presumption that if you truly ceased to be a Canadian resident, you would sell your house and take all your personal property and cut ties with Canada. The fact you kept the house/personal property suggests that maybe your time outside of Canada is temporary (not determinative but rebuttal with evidence)
      - Evidence you could use: good investment; bad market right now (will sell later)

- **Practice Advice:** if client is moving outside of Canada forever, tell them to sell their house so they don't run into this issue.
- While the residential ties of the individual (and their spouse/partner and dependent children) is the most important indicia, the CRA.courts will **collectively** consider **all relevant facts** including the following "secondary residential ties":
    - **Personal property located in Canada** (ie. furniture, clothing, automobiles, etc.)
    - **Social ties within Canada** (ie. memberships in Canadian professional associations, recreational, and religious organizations, etc.)
    - **Economic ties with Canada** (ie. employed with Canadian employer, involvement in Canadian business, Canadian bank accounts, professional memberships, etc.)*
        - * collectively I like to refer to these three indica as the "Secondary Big Three" (after considering the residential ties of the taxpayer and their spouse/partner/family)
    - Landed immigrant status or appropriate work permit in Canada
    - Canadian hospitalization and medical coverage
    - Canadian driver's licence
    - Canadian seasonal dwelling place or leased dwelling place
    - Canadian passport, landed immigrant status, etc.*
        - *this is not an exhaustive list
- These "secondary residential ties", particularly once you get beyond what I call "the Big 3" taken along, are typically given limited weight - but as they accumulate, they can become more influential in the overall residency determination.

<u>**Specific Issues in Determining the Residence of an Individual**</u>

- **Question:** assuming that an individual has properly been characterized as a Canadian resident under the common law, then can that individual change his/her status to a non-resident by physically living outside of Canada for a certain period of time?
    - **Answer:** The CRA had an admin policy that said if you are physically living outside of Canada for at least 2 years, the CRA would not challenge the individual for claiming they are non-resident (for more than those two years outside of Canada). However, the law is contained in the *Thomson* case. It is more about connections and there is uncertainty. There has been a change in the CRA's policy it is no longer 2 years its all about connections.
    - In para 1.17 of *Folio S5-F1-C1*, it states:

        Although length of stay abroad is one factor to be considered in making this determination [of Canadaian residency]...the Courts have indicated that there is no particular length of stay abroad that necessarily results in an individual becoming a non-resident. Generally, if there is evidence that an individual's return to Canada was foreseen at the time of his or her departure, the CRA will attach more significance to the individual's remaining residential ties with Canada in determining whether the individual continued to be a factual resident of Canada subsequent to his or her departure

- In paras 1.18 and 1.19 of *Folio S5-F1-C1*, the CRA states that **another factor** that it will consider in determining whether an individual intended to (and did) sever its residential ties with Canada is **whether he/she complied with the relevant income tax provisions engaged when a person ceases to be a Canadian resident**.
- For example, under **s. 128.1(4)**, when a taxpayer ceases to be a Canadian resident, then (among many things), the **Act generally <u>deems</u> the taxpayer to have disposed and reacquired at fair market value (FMV) all capital property except "taxable Canadian property"**

    - To the extent that such property has increased in value when it was acquired, then this deemed disposition and reacquisition will trigger gains for which Canadian taxes will likely have to be paid (or adequate security posted) - commonly referred to as an **"Exit Tax"**
- Canada has its own rule which is a disadvantage for non-residents acquiring Canadian residency - **S. 128.1** if a non-residency is acquiring Canadian residency, then immediately prior to that, that individual is deemed to dispose of and re-acquire all of his capital property at FMV

- **Practice Point:** we will no be further discussing the Canadian tax implications arising from ceasing to be a Canadian resident (or becoming one), but there are several important tax implications triggered by this change in status - so please consult competent tax advice when applicable

- Other points concerning the common law residency test (see *Folio S5-F1-C5* for further details):
    - **Every person has at least one residence for tax purposes at all times**
        - Put another way, it is impossible to not be a resident of a country for tax purposes
        - In *Folio S5-F1-C5* at para 1.21, the CRA seems to take this a little further (although this position is not new or controversial - at least in my opinion) - by stating that if a Canadian resident purports to sever his/her residency but does not appear to acquire a new residence, then the individual's remaining ties to Canada "may take on greater significance and the individual may continue to be resident in Canada"
    - **A person may be a resident in more than one country at the same time** - which can lead to a **"double tax"** problem (which may be alleviated through the election to rely upon the relief provided by a tax treaty)
    - **Residence is primarily a question of fact** - so too is the date of acquiring or severing a residence - which can sometimes be very important (see para 1.22 of *Folio S5-F1-C5* for more information)
        - b/c it is a finding of fact, you want to get to the tax court so they can do the review of info and witnesses, etc.
        - If you lose at the tax court level you will likely not have success at the appeal levels (b/c it is a question of reasonableness and they do not get the opportunity to oversee the information/fact process)
    - While a taxpayer's intention to reside in a particular jurisdiction may be relevant in deciding whether a taxpayer is a Canadian resident (see Justice Rand's definition above), this intention is not determinative, but "must always be viewed objectively against all the surrounding facts"
        - Where intention has been considered by the courts, it has most often been an "objective manifestation of intention" (intention derived from the facts in the case) as opposed to a subjective manifestation by the taxpayer (ie. "my intention is to not be a Canadian resident")
        - Further, there have been cases where courts have said that intention is irrelevant (ie. where a foreigner is incarcerated in Canada)
    - Generally speaking, **being a resident in another jurisdiction does not preclude an individual from additionally being a Canadian resident**
        - As noted, it is possible for a person to have more than one residence at a particular time
        - It is an examination of the residential ties (or lack thereof) to Canada which will govern the result for Canadian tax purposes - as opposed to establishing the residential ties to another jurisdiction
    - Appellant courts have repeatedly stated that the **standard of review** (at the Federal Court of Appeal and SCC) in a residency case is **"reasonableness"**
        - This means that to overturn the Tax Court's decision (in the case of determining whether someone is a Canadian resident), **the appellant must prove (on a balance of probabilities standard) that the Tax Court made a "palpable" (obvious) and "overriding" (changed the outcome of the case) error.**

- Where an individual is resident in Canada for part of a taxation year and a non-resident for the other part, **s.114** applies to tax the individual's worldwide income for that period of time that the individual is a Canadian resident and tax the individual's Canadian source income for the remaining period that they were a non-resident*
  - * **s.114** is required to mitigate the potential harshness of **s.2(1)**, which provides that if a person is resident in Canada "at any time in the year", that person's worldwide income for the entire year is taxable in Canada
- Given the uncertainty that always exists with using a factual analysis to answer a legal question, the CRA will provide a ruling on an individual's Canadian residency status if the individual submits a completed **Form NR-73** (if leaving Canada) or **NR-74** (if entering Canada)

Provincial Residency for Individuals

- Step 1: determined that an individual is resident in Canada using the common law indica
- Step 2: determine where the individual is resident for **provincial/territorial tax purposes**
  - This can be a significant given the differences in provincial/territorial tax rates (both for low and high income earners) as we will discuss in a subsequent Unit*
    - *to do a proper analysis, one must not only consider provincial/territorial tax rates, but also the corresponding tax credits
- Just as for determining Canadian residency under the common law, the **same basic test is used for determining provincial residency** (comprehensive factual analysis to identify significant residential ties) with **one important modification**
  - For **provincial/territorial tax purposes**, generally speaking, **the test is applied on December 31 of the year and the results of the test determine the individual's residency for the entire taxation year** (generally Jan 1 to Dec 31 for individual taxpayers)
    - Where an individual cease to be a Canadian resident before the end of the year, then the test is applied as of the last day the person was a Canadian resident (and then applies for that taxation year up to the point in time that the individual ceased to be a Canadian resident)
- Furthermore, where an individual has residential ties in two (or more) provinces/territories on Dec 31, then **Regulation 2607** provides that you "break the tie" by selecting that province/territory which may reasonably be regarded as the person's "principal place of residence"*
  - Can't be a resident in two Canadian provinces/territories in the same year
  - *as a matter of tax policy, this is different than in the case of determining a person's country of residence for tax purposes (for which the policy/principles is that a person can be resident of more than one country at the same time)
- **Practice Point:** this provincial/territorial test creates tax planning opportunity

Case Example - *R v Smale* 2009 CarswellSask 243 (Sask. QB)
Facts:

- Mr. Smale was born, raised and educated in Saskatchewan. Up until Feb 2995, he lived (with his wife and two children) and worked in Saskatoon as a chartered accountant; his wife also worked outside of the home in Saskatoon. The family home was jointly owned by Mr. and Mrs. Smale.
- While he moved to Calgary in Nov 2005 to begin work, he left his wife and kids behind; the "plan" was that they would join him in Calgary sometime towards the end of June 2006 after their younger daughter finished Grade 11 (in Sask). The family's plan to join Mr. Smale in Calgary was pushed back to June 2007 at the daughter's insistence to allow her to finish Grade 12 in Saks.

- FOr the first week (or so) Mr. Smale lived in a Calgary hotel; very soon, he found an apartment, brought a carload of personal items from his home in Saks and purchased roughly $3,000 of furniture. He also (quickly) changed the address for his credit cards, bank statements, provincial Institutes of Chartered Accountants, etc. to his new Calgary address. In Feb 2006, he obtained an Alberta drivers license and registered his car with Alberta registries. In Nov. 2006 he applied for Alberta health care coverage which he obtained
    - **Note:** the "rule: for obtaining Alberta Health Care coverage was that he couldn't apply until his Saks coverage (which lasted 12 months after he left the province) expired.
- Every 6 weeks (or so), Mr. Smale drove back to Saks (presumably on the weekends) to spend time with his family*
    - *unclear from the decision when (and for how long) these visits back to Sask occurred)
- On his 2005 income tax return (and presumably in subsequent years), Mr. Smale filed as an Alberta resident subject to Alberta, rather than Sask provincial tax rates
- The CRA reassessed his 2005 return on the basis that he was primarily a Sask resident in 2005 (and hence subject to the higher Sask rates)
- In Mar 2007, Mr. and Mrs. Smale decided to separate (possibly due to the strains of living apart since Nov 2005). Mrs. Stayed in Sask; Mr. Smale stayed in Calgary.

Issue: where was Me. Smale resident for provincial tax purposes for his 2005 taxation year?

- (Notes: as we will discuss in more detail in subsequent unit)
- **The Minister's assemest is presumed to be correct** (as well as valid and binding) pursuant to **s.152(8)**. Consequently, the **initial legal burden is on the taxpayer to disprove the Minister's assessment** (in this case, that Mr. Smale was a Sask resident)
- Assuming that the taxpayer overcomes the initial legal burden, then it shifts to the Minister to bring sufficient evidence and make sufficient arguments to support its assessment (which, if successful, shifts the burden back to the taxpayer, etc.)
- Even though Mr. Smale moved to Calgary in Nov 2005 (meaning that, at most, he resided for only 2 out of 12 months in Alberta, residing the 1st 10 months in Sask), assuming that he indeed acquired Alberta residency (and severed his Sask residency) then as we have just discussed, he was entitled to report and pay tax on his entire 2005's income using Alberta rather than Sask provincial income tax rates (since he would have been an Alberta resident on Dec 31, 2005)
- Generally speaking, the Tax Court of Canada has exclusive original jurisdiction over tax cases, there are several exceptions. This type of case is one - b/c it deals with **provincial**, as opposed to Canadian residency. This is why this case was heard and decided by the SCQB rather than the Tax Court
- Other minor issues such as discussion/conclusion about how to name the Respondent (in practice, this issue does not have a clear or unanimous answer)

Analysis: in my opinion, this decision could have gone either way

- The CRA (quite reasonably) argued that since (a) Mr. Smale had a home immediately available for him in Sask, (b) his wife and dependent children continued to live in Saks, and (c) he went back to visit every month or so, he continued to be a Saks resident for provincial tax purposes (at least for the 2005 taxation year)
- To the contrary, Justice Popescule (as he then was) found that Smale in mind and in fact had moved his residency to Alberta as of the end of Nov 2005.

Statutory Deeming Rules

- In addition to CL rules for establishing residency, there are also statutory rules which deem an individual to be a Canadian resident for Canadian income tax purposes.

    - Note: these rules are separate and apart from the common law test described above
    - Put another way, an individual may be found not to be a Canadian resident using the common law test but will still be a Canadian resident by virtue of the statutory deeming rules
- These deeming rules are contained in **s.250** and can be broken down into two categories (with regards to individuals):
    - **Sojourner Rule - paragraph 250(1)(a)**
    - **Special Individuals* rules - paragraph 250(1)(b)-(g)**
        - *Sprysak's terminology not the Act's

<u>Statutory Deeming Rule #1: "Special Individuals"</u>

- **Paragraph 250(1)(b)-(g)** identifies several groups of individuals who typically (or regularly) work for or on behalf of the Canadian gov't abroad, namely:
    - Members of the Canadian forces
    - Gov't officers/servants (loosely defined - quite a broad category)
    - Children (and certain spouses) of the above
- B/c these individuals (and their families) are living and working abroad, it is unlikely that they will be found to be a Canadian residents under the common law test
    - However, **s. 250(1)** deems them to be Canadian residents and taxed in Canada on their worldwide income
    - **Notes:** to prevent such individuals from being "double taxed" on their income (since they will likely be resident in the foreign country in which they are living and working), the foregin country will typically either deem them to be a non-resident for the country's tax purposes or non-taxable
        - Canada follows the latter approach with respect to foregin diplomats, military, etc. living and working in Canada - see **paragraphs 149(1)(a)** and **(b)**

<u>Statutory Deeming Rule #2 - Sojourner Rule</u>

- The **Sojourner Rule** in **Paragraph 250(1)(a)** deems an individual to be a resident in Canada **for the entire year** if that individual **"sojourned" in Canada for 183 days or more** in a particular calendar year.
- **Question:** What does it mean to "sojourn" for income tax purposes?
    - **Answer:** As "sojourn" is not defined in **s.248(1)**, the courts have relied on the **dictionary definition**, which is "to stay temporarily in a foreign land as opposed to ordinary residence; to make a temporary stay in a place; to remain or reside for a time; a place where one unusually, casually or intermittently visits or stays."
    - This is also the approach the CRA takes in *Folio S5-F1-C1* para 1.33, which states that sojourning "means to make a temporary stay in the sense of establishing a temporary residence, although the stay may be of a very short duration"
- **Notes:** these definitions do not refer to (or generally care about) the purpose of the visit - other than it is "temporary", "unusual", "intermittent", etc. As a general rule, it does not matter if the person is in Canada for work, for play stopover on a flight, etc.
    - **The one exception** to this statement that has been recognized by the courts is **where an individual comes into Canada for the day to work and then leaves Canada once she is finished for the day.**
        - In at least one case*, the court held that this did not constitute "sojourning" for Canadian income tax purposes
            - * *R&L Food Distributors Ltd. v MNR* (1977) C.T.C. 2579 (TRB). TRB stands for "Tax Review Board", which was a predecessor to the Tax Court of Canada.

        - In *Folio S5-F1-C1* para 1.33, the CRA characterizes this situation for income tax purposes as "**commuting**" rather than **"sojourning".**
    - This exception allows a person living in, say, Seattle, USA to work in Vancouver without having her worldwide income subject to tax in Canada on the basis of being a deemed Canadian resident.*
        - * Of course, the non-resident would be subject to **Canadian tax** on her Canadian source employment income pursuant to s. 2(3) and s.115 unless alleviated by the Canada-US Tax Treaty
        - Note: The CRA's position is that if the individual does not return home after working that day but instead stays overnight in Canada, this exception will not apply and the individual will be held to be "sojourning" under the Act
- **Question: what constitutes a "day" for purposes of the sojourner rule?**
    - **Answer:** to my knowledge, this continues to be somewhat of an unresolved question; it is not defined/specified in the Act
    - *Folio S5-F1-C1* para 1.33 states that as a general rule, the **CRA considers any part of a day to be a "day"** for the purposes of determining the number of days that an individual has sojourned in Canada in a calendar year
        - That said, para 1.33 states that the **nature of each stay must be examined separately** to determine whether the individual is sojourning or not (which it describes as a question of fact).
    - **This position has not been unanimously accepted by the courts.** Different judges have made different interpretations of "day" for purposes of the sojourner rule.
        - Generally speaking, the courts have rejected the notion that day requires continuous "24 hours"
        - Some agree with CRA's interpretation/position that any part of the day counts as one day
        - Others have stated that you do not count the day you entered Canada but you do count the day you leave Canada (where you are in Canada for over 2 days)

- **Tax Tip:** be careful of your non-resident clients inadvertently triggering the sojourner rule - assume all portions of each day in the country count and keep track when you might be coming close to the 183 day threshold
- **Important:** the sojourner rule is applied on a **calendar year basis**, with each calendar year treated separately/distinctly
- As confirmed by paras 1.30 and 1.32 of *Folio S5-F1-C1*, the sojourner rule **does not apply to factual residents** under the common law test (which, by implication, sets out the ordering in application of the 2 tests - common law test first, sojourner rule second)

- **Example**: Afshaan is a common law resident of Canada for the first 5 months of 2019 (assume 150 days). She then severs all of her Canadian residential ties and establishes new residential ties in Palm Springs, USA, where she continues to reside today. However, during the remaining 7 month of 2019, she spends 60 days in Canada visiting her Canadian friends
    - **Question:** how is Afshann's 2019 taxation treated for Canadian tax purposes?
    - **Answer:** will pay Canadian tax on her worldwide income for the first 5 months and then will pay Canadian tax on her Canadian source income for the remainder of 2019 as a non-resident
        - **Common Law Test**

        - **Sojourner rule -** days she is under the common law do NOT count as sojourning days. So do not count the 150 days she was a canadian resident. For the remaining part of the year she only spent 60 days so she is not past 183 days under sojourning
        - **S. 114** - separates the taxation year into 2 components (1. Subject to Canadain tax on her worldwide tax (s. 2.1), 2. Non-resident subject to tax under 2.3 unless the sojourner rule applies
- Note: If you fall under the sojourner rule, you are deemed to be a **Canadian Resident** for the entire year. However, the sojourner rule does not deem the individual to be a resident of a particular province*
    - To “fill the gap”, **s. 120(1)** imposes a federal surtax (in lieu of the provincial/territorial income tax that a Canadian resident would pay).
    - *as noted in *Folio S5-F1-C1* para 1.30, the deemed Canadian resident will not be entitled to any provincial tax credits or benefits

<u>Residence of an Individual - Summary</u>

- There are two main ways that an individual can be considered a Canadian resident (and hence be subject to Canadian income taxation on his/her worldwide income):
    - Under the common law test as described in the *Thomson* case, or
    - Under one of the statutory deeming rules (most commonly, the sojourner rule)
- In order to be sure that an individual is **not** a Canadian resident, one must apply the common law test and consider the application of the statutory deeming rules (typically in that order).
- B/c there are two ways of having Canadian resident status (and may countries have the same or similar rules as Canada), it is possible for an individual to be resident of Canada and another country (under each country’s domestic income tax law) at the same time
    - This can result in the individual’s worldwide income being subject to tax in both jurisdictions unless some relief is available (either within the domestic tax law or through a tax treaty) - discussion of the issue is beyond scope of this course

A Brief Overview of Corporations

- Under corporate law, a corporation is a **legal entity** that is **distinct** from its owners (ie. shareholders), its employees, and anyone with whom it deals.
    - This is important - particularly for individuals who own all of the shares of a private corporation. In my experience, it is not uncommon for such individuals to think that b/c they own all of the shares of the corporation, the assets belong to them as opposed to a separate and distinct legal entity. This line of thinking (and behaviour consistent with this line of thinking) often results in “tax trouble”.
- The governing legislation will set out how the corporation is brought into legal existence (through incorporation), its capacities and powers (ie. to enter into contracts, carry on a business, own property, etc.), how it can raise funds using equity and/or debt, the rights and responsibilities of its directors, officers, shareholders, etc.
- As we learned, consistent with corporate law, **a corporation is a person for tax purposes**, meaning that pursuant to **s. 2(1)**, if resident in Canada, it is required to calculate its worldwide taxable income for its taxation year and pay Canadian corporate income taxes
    - Once such taxes have been paid, the corporation is free to distribute its “**after-tax corporate income”** to its shareholders as dividends
    - Whether and how such dividends are taxed to the shareholder(s) will depend on (a) who the shareholder receiving the dividend is (ie. corporation, individual, trust, non-taxable entity) and (b) how the income was taxed in the corporation

- While there are **usually two levels of taxation with respect to corporate income that is distributed to an individual shareholder** (ie. the corporation and individual shareholder levels - “double taxation”), Canada's Tax system has been designed to try to ensure that the **total taxes levied on such income is equal to the amount of tax that the individual shareholder would pay if she earned the income personally.**
    - This is referred to as the **principle of integration** as it often accomplished using the “dividend gross up and tax credit mechanism”

Simple Example of the Concept of Integration of Corporate and Personal Income

- **Assumptions:**
    - A Canadian resident individual carries on a business that generates $1,000 of pre-tax income per year
    - The applicable tax rates are:
        - 40% for individual taxpayers
        - 25% for corporate taxpayers

- **Scenario 1: The individual Carries on the Business Personally (ie. Unincorporated activity)**

Business Income	$1,000
Personal Tax* 40%	<400>
After-Tax Personal Income	$600

- *__Taxes = Pre-Tax Income * Tax Rate__

- **Scenario 2: The Individual Carries on the Business Through a Corporation**

Corporation:	Business Income	$1,000
	Corporate Tax 25%	<250>
	After Tax Corporate Income	$750
Individual:	Dividend Received	$750
	Net Personal Tax	<150> (Note #1)
	After-Tax Income	$600

Note #1: to calculate the appropriate amount of personal tax on a dividend, one must employ the “gross up and dividend tax credit regime”, illustrated below:

Actual Dividend Received	$750
Notional Gross Up	250

Gross Up Dividend	$1,000
Personal Tax*	<400>
Dividend Tax Credit**	250
Net Personal Tax	<$150>

*Personal Tax is calculated by taking the Grossed Up Dividend among and multiplying it by the (assumed) personal tax rate (ie. 40%)
**Dividend Tax Credit - the calculations of the DTC are contained in the Act - though the details are beyond the scope of this course

- **Questions:** what evaluative goal(s) studied in Unit #1, if any, does the principle of integration satisfy?
  - **Answer:** goal of neutrality or efficiency - one that doesn't influence behaviour of individuals

Residence of a Corporation

- Just as is the case for determining the residency of an individual, there is **common law test** and **statutory deeming rules** for determining the **residence of a corporation** for Canadian income tax purposes
  - Consequently, just like for determining whether an individual is a Canadian resident, one must consider both before being able to come to a correct conclusion
  - **Note:** unlike the case for determining the residency of an individual (for which you start with the common law test before proceeding to the sojourner rule), there is no implicit ordering in determining the residence of a corporation
- Beginning with the **statutory deeming rules** (which are generally the easier of the two to apply), the most common rule is contained in **paragraph 250(4)(a)**, which provides that is **a corporation is incorporated in Canada after April 26, 1965**, then from that point forward (unless continued into another country or another rule applies), it will be a Canadian resident corporation
  - This covers the cast majority of Canadian-incorporated corporations in existence and any incorporated today (and in the future)
  - If a corporation is incorporated in Canada (say Sept 1) and then is **continued** into (say) the US on Sept 30, then for tax purposes (pursuant to **s. 250(5.1)**), **it is treated from the point of continuation to have been incorporated in the US (and not ever have been incorporated in Canada)**
    - Conversely, if a corporation is incorporated in the US and then continued into Canada, **s. 250(5.1)** will deem that corporation to have been incorporated in Canada as of the date of continuance (so be careful if doing this corporate law procedure)
- The **common law test for corporate residency** is based upon a quote from Lord Loreburn's decision in *De Beers Consolidated Mines Ltd. v Howe* (1906), where he said:

  - In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A corporation cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business...A company resides for purposes of income tax where its real business is carried on… I regard that as the true rule, and the real business is carried on where the **central management and control** actually abides

- Not surprising, this test became known as the **"central management and control test"** and, like the *Thomson* test for individuals, is **primarily a question of fact** (but practically speaking, not as difficult to apply and uncertain in result as the factual test for determining whether an individual is resident in Canada)
- To determine where a corporation's "central management and control" is exercised, courts will typically look to **where the corporation's Board of Directors meet and make decisions**
  - Generally speaking (unless the Board is the shareholders' "puppet"), the residence status of the corporation's shareholders is irrelevant in determining the corporation's residence for Canadian income tax purposes
  - However, where one or more shareholders are effectively controlling the corporation (ie. the Board is the shareholders' "puppet"), then central management and control will be found to be exercised where the shareholder(s) reside(s).

Example: *Landbouwbedriff Backx B.V. v The Queen* (2018 TCC 142)
- **Facts:** The Backxes (Michiel and Marian) were the initial directors (and shareholders) of their Netherlands corporation and were residents in the Netherlands until they decided to immigrate to Canada
- At this time, they resigned as directors and appointed (as shareholder) Marian's sister Anna Van Gorp, who continued to reside in the Netherlands, to be the sole director
- **Analysis:** Justice Smith agreed with the Minister that Anna was not acting as a true director, but only as an "administrator who implemented the Backxes instructions*
  - *Justice Smith went on to note that Anna had no relevant business or directorial experience that she could have used to act as a "true director". He then concluded (at para 46) that Anna was a "mere nominee who carried out clerical and administrative functions on behalf of the Backxes"
- Put another way, Justice Smith found that the Backxes were the *de facto* ("in fact") directors - and hece where they made decisions regarding the corporation constituted the place where central management and control was being exercised*
  - *as noted above, the actual common law test for determining the residence of a corporation is where the Board of Directors meets and makes key corporate decisions - so if the Backzes flew back to the Netherlands and held their Board meetings there, the corporation would continue to be resident in the Netherlands, as opposed to Canada
- As theses decision were made in Canada, the corporation was resident in Canada and hence liable to Canadian income taxes on its worldwide income
- In so doing, he confirmed (at para 42) that **"cogent evidence is required to displace the well-established notion that *de jure* directors hold primary responsibility for the management and control of a company. Such evidence must clearly establish that the "outsider" has 'effective' or 'independent' management and control***
  - *"De jure" means "at law" - so "de jure Directors" would be the directors that were appointed by the shareholders

Practice Points:
- In deciding which jurisdiction to incorporate and who will be the directors, consideration should be given to the implications to the corporation's residency status for income tax purposes.
  - More specifically, if you want a corporation resident only in Canada, then should incorporate it in a Canadian jurisdiction and make sure the DIrectors are Canadian residents who meet and make fundamental corporate decisions in Canada

- Conversely, if you want a non-Canadian resident corporation, then you need to incorporate it pursuant to foreign legislation and appoint non-Canadian resident directors to the Board who properly exercise their Board functions outside of Canada
- **While generally not relevant for residency purposes**, consideration should also be given to the residency status of the shareholders - particularly if dealing with a "private" corporation
  - "Canadian controlled private corporations" as defined in **s. 125(7)** are subject to several benefits under the Act (including potential access to the "small business deduction"
  - To preserve this benefit (and others), you want to ensure that no controlling shareholder (or group of shareholders) are non-residents of Canada

A Brief Overview of Trusts

- Generally, a "trust" is (a) a relationship, (b) with respect to property, (c) whereby there is a **separation of legal and equitable interest**, such that the legal owner of the property (the trustee) holds such legal ownership for the benefit of the equitable owner (the beneficiary) in such a manner that the law finds the trustee to have a **fiduciary duty** to the beneficiary
  - To be clear, **under the general law, a trust is not recognized as a separate legal entity like a corporation is**; the law recognizes the trustee as the legal owner and the beneficiary(s) as the equitable owner(s)
- In order for a trust to come into existence, **three certainties** must be present, namely:
  - **Certainty of intention:** to create a trust (as opposed to say, make an outright gift, bailment, lease, licence, etc.)
  - **Certainty of subject matter:** which is comprised of two main features (1) certainty of the property that is subject to the trust and (2) certainty of the respective shares/interest each beneficiary has in such trust property; and
  - **Certainty of object:** which usually refers to the beneficiaries that the trust is created for, but could also refer to the beneficiaries that the trust is created for, but could also refer to the purpose/use of the trust (and trust property)
- Note: it is not uncommon for a court to find that a trust hasn't been created b/c it hasn't satsified all of the requirements to be a trust
- If a settlor creates a trust when they are alive, then it is an ***inter vivos trust***; alternatively, if the trust is created as a consequence of the settlor's death, then it is generally called a **testamentary trust**
  - For our purposes, an **"estate"** can be defined as "the real and personal property that a person possesses at the time of death and that passes to the heirs or testamentary beneficiaries
- Generally speaking, trusts are used primarily for two related purposes:
  - **To preserve assets** for the use of certain persons without giving up a trust to benefit our daughters, wout giving our daughters full ownership rights over the trust assets)m and
  - **To protect assets** from others (ie. I set up a trust for my wife and kids and legitimately put our personal assets and savings into the trust so that if I get successfully sued, my creditor can't take these assets away and hurt my family)
- While the law generally does not recognize a trust as a distinct legal entity, as we have learned earlier in this Unit, **Canadian tax law does recognize a trust (and an estate) as a "person: separate and distinct from the settlor, trustee and beneficiary(s)** pursuant to **s. 248(1)**
  - As such, just like a corporation a trust, if resident in Canada, must calculate and report its taxable income and taxes on a trust tax return (T3 Tax Return)
- In this regard, it is important to note that generally speaking:
  - **S. 104(1)** provides that trusts and estates are generally treated the same for tax purposes, and

- **S. 104(2)** provides that a trust/estate is **generally treated as if it was an individual taxpayer - unless there is a specific provision in the Act which provides special tax treatment for trusts (of which there are many)**
- Some of the exceptions to theses general rules include:
  - **s.122(1)**, which generally provides that **all of trust's income** (other than income from a "graduated rate estate" - discussed below) **is taxable at the highest marginal rate for individuals** (as opposed to all of the marginal rates/brackets applicable to individuals)
  - A **"graduated rate estate"** (GRE) is defined in **s. 248(1)** as: (a) the deceased's estate for up to 36 months after the deceased's death*, (b) that has been designated as the deceased individuals' GRE for income tax purposes
    - *after the 36 month period expires, if the estate is still in existence (ie. all of the property has not been distributed to the beneficiaries), the estate loses its special stats as a GRE and is taxed as a testamentary trust - meaning all of its income is taxed at the highest marginal rate
    - Unlike *inter vivos* and testamentary trusts, **a GRE is entitled to all of the marginal tax brackets and rates as if the trust was an individual taxpayer** - but only while a GRE
  - **S. 122(1.1)**, which provides that trusts cannot claim personal tax credits (which individual taxpayers may be eligible to claim)
- In some respects, the relationship b/t a trust and its beneficiaries is analogous to the relationship b/t a corporation and its shareholders for tax purposes. More specifically:
  - Corporations and trusts are persons for income tax purposes distinct from their respective shareholders and beneficiaries
  - To the extent that corporations and trusts earn income, they may be required to complete a tax return (T2 for corporations, T3 for trusts) and pay taxes
  - Similarly, to the extent that shareholders and beneficiaries receive distributions from their corporation or trust, the shareholders and beneficiaries may have to report such distributions on their tax returns and pay taxes
  - Canada has structured its income tax regime to generally avoid such distributions being "double-taxed"- although the way the Act accomplishes this in the context of trusts and beneficiaries is **different** than for corporations and their shareholders
  - That said, there are also significant differences in the tax treatments of (and the common tax strategies associated with) corporations and trusts

<u>Determining the Residence of a Trust</u>

- While we have noted that for both individuals and corporations, there are both common law tests and statutory deeming rules, in the case of trusts, there are no general statutory deeming rules*, but only a common law test which is contained in the SCC decision in *Garron Family Trust (Trustee of) v R***
  - *The closest the Act has is some provisions (ie. **s. 94(3)**) which eem n otherwise factually non-resident trust to be a Canadian resident for certain purposes. These deeming rules are beyond the scope of this course.
  - **[2012] 1 SCR 520 - this case involved a trust with a trustee (corporation) resident in Barbados and Canadian resident beneficiaries. When the trust sold its share in Ontario corporations for a very sizable capital gain, the trust sought a treaty exemption from Canadian tax on the basis that the trust was resident in Barbados. The Minister of National Revenue took the contrary position that the trust was resident in Canada and hence Canadian taxes applied to the gain
- In the SCC decision (which largely upheld the decisions of the Tax Court and Federal Court of Appeal*), the Court, after acknowledging the similarities b/t a corporation and a trust**, **adopted the common law test for determining the residency of a corporation - namely the "central management and control" test.**

    - *The SCC explicitly noted that it was not addressing some of the other arguments made by the Minister involving other provisions of the Act that its decision should not be interpreted as endorsing the Federal Court of Appeal's reasons on those alternative arguments/provisions
    - **at para 14, the Court notes that: (1) both corporations and trusts hold assets that are required to be manage; (2) both involve the acquisition and disposition of assets; (3) both may require the management of a business; (4) both require banking and financial arrangements; (5) both may require the instructions or advice of lawyers, accountants and other advisors; and (6) both may distribute income
- At para 15, the Court state, "as with corporations, residence of a trust should be determined by the principle that a trust resides for the purposes of the Act where 'its real business is carried on', *which is where the central management and control of the trust takes place"*
    - While this will normally be the named trustee(s) resides and exercises power over the trust assets*, it does not have to be
        - *In para 15, the Court states, "the residence of the trustee will also be the residence of the trust where the trustee carries out the central management and control of the trust, and these duties are performed where the trustee is resident"
    - More specifically, if someone other than the named trustee(s) is exercising central management and control over the trust (and perhaps the named trustee is only providing "administrative services"), then the place that the other person is exercising central management and control over the trust will determine the residence of the trust*
        - *In *Garron*, the Tax Court found as a fact that the Canadian resident beneficiaries, as opposed to the Barbados trustee, were exercising central management and control over the trust - and this finding was upheld by both the Federal Court of Appeal and the SCC.
    - The SCC decision in *Garron Family Trust* is reflected in Folio S6-F1-C1: *Residence of a Trust or Estate* (25 November 2015)

- **Practice Points:**
    - Just like for corporations, the current law for determining the residency of a trust for tax purposes focuses on where the "central management and control" of the trust is exercised - which requires a **full factual analysis**
        - Reliance on the trust indenture and the residence of the named trustee(s) is no longer sufficient
    - In my opinion, the key issue under this new test, which was no discussed by the SCC, is **what functions (and the level of such functions) will constitute "central management and control"**, particularly where the argument is (by the CRA) that these functions are being exercised by someone other than the trustee?

- **Question:** so what (objective) evidence might indicate that the named trustee is in fact exercising "central management and control" over the trust property - as opposed to say, the beneficiaries?
    - **Answer:** some evidence that has been accepted/relied upon in the post-*Garron* case law includes the trustee:
        - Asking for relevant information before acting/making a decision;
        - Seeking independent legal/tax advice where appropriate;
        - Considering the likely implications to the Trust and/or beneficiaries of a particular proposed action;
        - Declining the request from a particular beneficiary where the Trustee believed that it was prejudicial to one or more of the other beneficiaries; and

Unit 4 - The Administration of Income Tax Law

- Don't always need to go through every step

Step #1 - Taxpayer

- **General Rule:** Typically, the starting point in any discussion regarding the administration of federal income tax law is **subsection 150(1)**, which provides that a taxpayer **generally** must prepare and file an income tax return for each taxation year "without notice or demand" from the CRA.
  - For **individuals**, the general rule is contained in **paragraph 150(1)(d)**, which requires individuals to file their return for the preceding "taxation year" (ie. calendar year) by **April 30th.***
    - *Individual taxpayers have until June 15, where the individual (or his/her cohabiting spouse or common law partner) is carrying on a business per **subparagraph 150(1)(d)(ii)**, although interest on any outstanding balance starts accruing after April 30. **Note:** you will not be examined on this exception to the general rule that individual returns be filed by April 30 of the following year.

  - In the case of **deceased individuals, paragraph 150(1)(b)** provides that "in the case of an individual who dies after October of the year and before the day that would be the individual's filing due date for the year if the individual had not died", the deceased's representative has until the **later** of:
    - The date on which the return would otherwise have to be filed, and
    - The day that is 6 months after the date of death

- **Question:** Stephane passed away on Feb 10, 2019, without having filed her 2018 (or 2019) tax return. When do these returns have to be filed by her executor?
  - **Answer:** her **2018 return**, which is normally due April 30, 2019, needs to be filed within 6 months of Feb 10, 2019, so **Aug 9, 2019.** Her 2019 return (which would include her income from Jan 1, 2019 to Feb 10, 2019) is due at its normal time of **April 30, 2020.** Any income after feb 10, 2019 would be filed by her graduated rate estate (GRE)*.
    - *her GRE would be able to have a non-calendar taxation year if desired - but only for the first 36 months of its existence.
  - Note: where April 30 (or any other applicable deadline) falls on a weekend or statutory holiday, then the deadline is extended until 11:59 PM of the next business day.

Exceptions to the General Rule: the general requirement to file a yearly tax return in **subsection 150(1)** is then **modified** by **subsections 150(1.1.)** and **(2)** as follows:

- **Subsection 150(1.1)** generally provides that an **individual does not have to file a tax return if** s/he (a) does not have a tax liability, (b) has not disposed of capital property (or otherwise has a taxable capital gain), and (c) does not have a positive balance in a Home Buyers Plan or Lifelong Learning Plan, but
- **Question:** how can you know with some certainty that you do not have an outstanding tax liability?
  - **Answer:** file a tax return even if they don't owe taxes

- **Subsection 150(2)** provides that an individual **must** file a tax return **if furnished with a demand to do so by the Minister** (even if the individual fits within the exceptions contained in **subsection 150(1.1)** - "exception to the exception")

Practice Point: while an individual might not technically be required to file a tax return by virtue of an "exception" contained in **subsection 150(1.1),** there are advantages to filing a yearly tax return on time, including:
- Receiving the GST (refundable) credit and gov't child support benefits
- Being able to transfer tuition tax credits to a spouse, common-law partner or parent
- Acquiring the ability to contribute to a RRSP, and
- Perhaps most importantly, starting the statutory limitation period running (which we will discuss in more detail below)

Step #2 - The CRA - Review and Issue Assessment

- Once the CRA receives an individual's income tax return*, then **subsection 152(1)** requires it to review it and assess the taxpayer's tax, interest, penealites, tax refund, losses, etc. (as applicable) for the year "with all due dispatch" pursuant to **subsection 152(2).**
    - ***The CRA receives approximately 56 million income tax and GST returns each year from individuals, corporations, and trusts.
- This Notice of Assessment is commonly referred to as a "desk assessment" as it is typically done from the CRA's office (as opposed to after conducting an audit)*
    - *it is alternatively referred to as an "initial assessment"
- **Note:** this does not mean that the CRA doesn't already have other information in its possession (ie. tax information slips) that is uses to verify the accuracy and completeness of the taxpayer's return

Important Points:
- The CRA does not have to wait for the taxpayer's return to issue a Notice of Assessment nor is it bound by the information contained in the taxpayer's return.
    - Indeed, **subsection 152(7)** gives the CRA the power to issue a NOA where the taxpayer has not submitted a return
    - This is commonly referred to as a "net worth assessment" as the CRA estimates the taxpayer's income over a period of time by comparing the taxpayer's net worth at the beginning and end of that period

- The issuance of this first assessment is important for a variety of reasons, including that it generally **starts the statutory limitation period** during which the CRA can go back, audit, and reassess a taxpayer.
    - For individuals, **subsection 152(4)**, in conjunction with **subsection 152(3.1)** generally provides that this statutory limitation period is **3 years after the date the initial assessment is sent.**
        - **Subsection 244(14)** and **(15)** collectively (and rebuttably) presume that the date the assessment is made is the date on the assessment
    - Consequently, if no return is submitted and no assessment is issued, **the statutory limitation period does not start** - which taxpayers who don't file a tax return don't appreciate - they are continuously at risk!
    - As further set out in **subsection 152(4)**, there are several cases where the CRA will have a longer period to reassess a taxpayer.

    - In **subparagraph 152(4)(a)(i)** - where a taxpayer has "made any **misrepresentation** that is attributable to **neglect, carelessness or wilful default, or has committed any fraud** in filing the return or in supplying any information under the Act"
    - Where the CRA is alleging that one or more of these requirements are satisfied (with the **CRA bearing the burden of proof** of the existence of the requirement), **then the CRA has an unlimited time period in which to aduit/reassess (as confirmed by subsection 152(4.01)**

Note: pursuant to **subsection 152(8)**, an assessment (or reassessment) is "deemed to be valid and binding notwithstanding any error, defect, or omission" in it

- This puts the initial legal burden on the taxpayer to disprove an assessment/reassessment - and applies to any assessment/reassessment issued by the Minister

Step #3 - The CRA

- As noted above, while the CRA is tasked with issuing a NOA in response to receiving the taxpayer's tax return, **this does not end the administration of that tax return.**
    - **For the next 3 years** (and possibly longer in certain situations - ie. neglect or fraud in the return), the CRA has the ability to audit pursuant to **section 231.1** and, if necessary, reassess the taxpayer's tax return
- **Question:** What could cause the CRA to audit a taxpayer (and his/her return(s))?
    - **Answer:** a variety of reasons including:
        - The taxpayer may have had an error(s) in his/her returns in prior years thesa not seem to be "inadvertent mistake";
        - The taxpayer may be involved in an activity (ie. cash businesses, construction, etc.) where there are typically more attempts to commit tax evasion;
        - Random selection - keeps everyone honest
- **Question:** what does an "audit" look like?
    - **Answer:** can be in a variety of forms, including:
        - A request for specific information (ie. receipts for union/professional dues, moving expenses, etc.),
        - A request for all supporting documentation for a particular tax return,
        - A request for supporting documentation for three years of tax returns, and
        - A site visit by a CRA auditor.
        - Perpetual auditing

Important Point: if the CRA decides to audit a taxpayer to see if his/her/ return complies with the Act, **paragraph 231.1(1)(d)** (along with other sections - ie. **subsection 231.5(2)**) **imposes a positive duty on the taxpayer to assist the CRA** in its audit.

- However, if the CRA is investigating whether the taxpayer may have committed **tax evasion** pursuant to **section 239 (or 238)**, which is a criminal offence, this duty to assist disappears and all of the *Charter* protections (ie. freedom from unreasonable searches and seizures, presumption of innocence, etc.) kick in

At the end of the audit procedures, the CRA will decide whether a Reassessment is necessary.

Step #4 - Taxpayer

- Assuming that the taxpayer has been audited and that the CRA has issued a **Notice of Reassessment** that increases the taxpayer's tax liability from what s/he reported on his/her return*, the taxpayer has two possible courses of action:
    - They can agree with the Notice of Reassessment and pay the additional taxes and interest (depending on the circumstances, penalties), or
    - They can dispute the Reassessment
    - *of course an audit could result in a Reassessment that reduces a taxpayer's taxable income and/or payable.

- To dispute a Notice of Reassessment, the taxpayer must file a timely **Notice of Objection** pursuant to **subsection 165(1)**, which must set out the relevant facts and the reasons for disputing the Notice of Reassessment
    - **General Rule:** a Notice of Objection must be submitted **on or before the later of:**
        - The day that is one year after the taxpayer's filing due-date for the year (ie. April 30, 2020 in respect of his/her 2019 tax return), and
            - April 30th 2021
        - The day that is 90 days after the date the **CRA mailed** the Notice of Reassessment
            - The date of mailing is assumed to be the date on the Notice of Assessment /Reassessment, and
            - It is 90 days after the date on the Notice, as opposed to the date the taxpayer received it, opened it, etc.

- Generally speaking, there is no official form/document that has to be completed to object to a NOA - but CRA as created **Form T400A *Objection - Income Tax Act*** to help taxpayers (and tax practitioners) draft and file a proper Notice of Objection.
    - Essentially, your objection should include the **facts surrounding the controversial item** and the **legal reasons why you are objecting** (ie. contrary to the case law, facts don't support the results, etc.)
    - **Note:** the reasons for disputing the Reassessment must be based in the law or on the facts (or the application of the law to the facts) - this is not a "fairness" or "economic hardship" type appeal
    - 3 objections:
        - Dispute to underlying facts
        - Misunderstanding or incorrect interpretation of the law (CRA used the wrong law)
        - Application of law to the facts may be incorrect

Step #5 - CRA

- Once the taxpayer's Notice of Objection is received by the CRA, it and the auditor's files on the taxpayer then go to an Appeals officer within the Appeals Division of the CRA in order to hold an **administrative appeal**
- The Appeal Division is still part of CRA, but separate from the Audit Division
- **Important Point:** as part of the administrative appeal process, you are able to request the CRA documents supporting the assessment/reassessment (ie. reports prepared by the CRA auditor (unless privileged), CRA auditor working papers copies of court decisions and the relevant sections of legislation relied on by the CRA

auditor, appraisal/valuation reports relied on,and information obtained from 3rd parties to support the Assessment, etc.)

- Once the taxpayer (and his/her tax advisors) obtain this information (or even without it in cases where the taxpayer/advisor is fully aware of the basis for the assessment/reassessment), the taxpayer/advisor will try to provide further information/evidence and/or make legal arguments to try to:
  - Resolve matters completely (and hence alleviate the need and cost to take the matter to court), or (at least)
  - Reduce the number of issues under dispute and clarify exactly what is being disputed (ie. is it an evidentiary issue or a question of law)
- After reviewing the matter and considering any further submissions from the taxpayer and their representatives, the Appeals Officer will either **confirm the Reassessment (Notice of Confirmation)** or issues a new **Notice of Reassessment**

Step #6 - Taxpayer

- If the taxpayer is still not happy with the current status of his/her tax return after the administratie appeal, then the next step is to file a **Notice of Appeal** to the Tax Court of Canada in a timely fashion pursuant to **subsection 169(1).**
  - **Important Point:** as set out in **subsection 169(1)**, before a taxpayer can appeal to the Tax Court, they must first file a **Notice of Objection** (ie. can't go directly to Tax Court from assessment)
    - That said, if the taxpayer is not happy with how the administrative appeal is progressing (or doesn't like their chances of success at this level), the taxpayer is able to file a **Notice of Appeal** after the administrative appeal has been ongoing for 90 days (but before a Notice of Confirmation/Reassessment has been issued)
  - **General Rule:** taxpayer has 90 days after the CRA mails a Notice of Reassessment of Notice of Confirmation to file their Notice of Appeal

Practice Point: timing of all these documents is critical. Failure to comply with a deadline could result in your client losing their appeal rights and in a professional negligence claim against you and your legal insurer.

<u>**Miscellaneous Points about the Tax Dispute Resolution Process**</u>

- Roughly 90% of all Notices of Objection file are settled/discontinued at the administrative appeal level
  - Of the remaining 10%, only approximately one third are actually heard by the Tax Court (TCC).
- Of the roughly 400 tax cases the TCC hears each year, more than half are decided in favour of the taxpayer.
- Less than 10% of TCC decisions are appealed to the FCA; less than 10% of FCA decisions are granted leave to appeal to the SCC.
- Like virtually all areas of the law, there is an access to justice issue in taxation cases (even despite the informal procedure rules).
  - ***Pytel v R***., [2010] 2 CTC 2429 (TCC - IP) is an example of an informal procedure case conducted by the taxpayer (in which the taxpayer experienced much frustration and difficulty with the process - which culminated with him storming out of the courtroom at one point).
  - While that is typically fatal to an appeal, in finding for the taxpayer, Chief Justice Rip (as he then was) acknowledged the difficulties a layperson has trying to run his own tax appeal - even using the informal procedure rules - and mae a plea for legal aid, *pro bono*, and student run tax litigation services
- Generally speaking, the cost incurred in disputing a Reassessment are deductible under **paragraph 60(o).**

<u>Disputes and Interest</u>

- Filing a Notice of Objection has two important functions:
  - **(1) - it preserves/activates a taxpayer's appeal rights** - no Notice of Object (and administrative appeal), no ability to file a Notice of Appeal to the Tax Court*; and
    - *subsection 152(8) deems an Assessment/Reassessment to be valid and binding
  - **(2)** - it (generally) **puts the CRA's collection activities on hold**
- However, filing a Notice of Objection (and Notice of Appeal) **does not stop the "interest clock"** on any outstanding tax liability (that is considered to be outstanding from the date the tax return was required to be filed and taxes paid)
  - Pursuant to **section 161**, interest is **compounded daily** at a prescribed rate that changes quarterly (6% for Jan to Jun 2020, 5% for July to September)
- **Important Point:** to protect a taxpayer from having to pay additional interest (beyond what has already been assessed) if unsuccessful in his/her administrative/judicial appeal, which states that **the payment is solely for purposes of stopping interest from accruing and not an admission or acceptance of the additional liability**. This way:
  - If the taxpayer wins the appeal, then the payment will be returned (along with interest); but
  - If the taxpayer loses the appeal, then no additional interest charges will apply.
  - **Note:** like the financial institutions, the rate of interest that the CR pays on overpayments is substantially less than the interest it charges on outstanding debts.

<u>The Burden of Proof in Tax Appeals</u>

- Generally speaking:
  - In civil trials, the person initiating the Statement of Claims has the initial legal burden of proof (on a balance of probabilities); and
  - In criminal trial, the Crown has the burden of proof (beyond a reasonable doubt)
- For tax cases, the burden of proof is as follows:
  - Where only the **taxpayer's compliance with the *Act*** is in issue, the relevant burden of proof is the **civil burden (balance of probabilities)**, and
  - Where the Minister is alleging that taxpayer has committed a **criminal offence** (ie. tax evasion), then the relevant burden on proof is the **criminal burden (beyond a reasonable doubt).**
    - Further, for criminal tax evasion cases (as opposed to civil cases - which are discussed below), the **Minister bears this initial legal burden** of proving the *actus reus* and *mens rea* components of the offence beyond a reasonable doubt.
- However, somewhat unlike non-tax civil cases, **the taxpayer bears the initial burden of disproving the Minister's assessment/reassessment***
  - *This was confirmed by the SCC in *Johnston v Minister of National Revenue*, [1948].
- More specifically, as was described in *Northland Properties Corporation v British Columbia* 2010 BCCA 177, based largely upon the SCC's decision in *Hickman Motors Ltd. v R*, [1997] 2 SCR 336:
  - b/c the Minister's assessment/reassessment is presumed to be "valid and binding" by virtue of **subsection 152(8)**, the taxpayer has the initial legal burden of proof to "demolish the Minister's assumptions in the assessment."
  - Put more simply, if the taxpayer does not successfully challenge the Assessment, the Assessment is considered correct and valid at law and the taxpayer is responsible for the tax liability as set out in the Assessment

- The taxpayer can overcome their initial legal burden in one of three ways:

    - (1) by challenging that the Minister in fact relied upon the state assumptions in coming to the assessment
        - If the Reassessment is not based on the stated assumptions (ie. the Minister pulled the Reassessment out of the air), then the Reassessment is invalid
        - The tax principle here, like the general legal principle, is that the taxpayer has the right to know the case before her
        - As you might imagine, this basis of appeal is rarely applicable and just as rarely successful

    - (2) by "demolishing" one or more of the Minister's assumptions on which the assessment is based - which can be done by bringing credible evidence that is contrary to the assumption
        - This is accomplished by the taxpayer making (at least) a *prima facie* case by providing sufficient evidence*
            - *in *Hickman Motors*, Justice L'Heureux-Dube (for the majority) at para 93 noted that "unchallenged and uncontradicted evidence 'demolishes' the Minister's assumptions.
            - **Note:** in *House v R*, 2011 FCA 234, Justice Nadon (for the Court) noted, based upon *Hickman Motors*, that (a) unless the Act requires supporting documentation, or (b) the taxpayer's credibility is in question, "**credible oral evidence from a taxpayer is sufficient [to demolish the Minister's assumptions] notwithstanding the absence of records."**

    - (3) by contending that, even if the assumptions were justified, they do not of themselves support the assessment (ie. improper application of the law to the facts).

- If the taxpayer is successful in this regard (on any or a combination of these 3 bases), then the taxpayer will win the tax appeal (and have the tax liability as set out in his tax return restored) <u>unless</u> the Minister is able to show (again on a balance of probabilities) that the Assessment is otherwise valid (by providing evidence/legal argument supporting this conclusion)
    - Put another way, once the taxpayer satisfies its initial legal burden, the burden shifts to Minister
    - If the Minister overcomes this tactical burden, then the taxpayer (again) has a "tactical burden" to successfully challenge the new evidence in support of the Minister's Assessment

- Taxable benefit - donating to charity but NEED tax receipt from the charity in order to claim. Another way is employment benefits for travel (gas mileage, etc.)

Practice Point: while we can talk about the initial and shifting burden, in a real case, there aren't such distinctions (particularly with respect to the shifting burden) - the Tax Court will hear the taxpayer's submission, then the Crown's and then come to a decision

Question: why does the taxpayer bear the initial legal burden?
- Answer: as a matter of practical efficiency, the taxpayer is the best person to know and provide the necessary information and evidence to calculate their tax liability - see eg. *Johnston v The Minister of National Revenue* [1948] SCC.
    - **Note:** this approach is only taken in respect of assessing the taxpayer's tax liability - "civil compliance" with the Act. As noted above, if the Minister is alleging tax fraud or other criminal offences, then like all criminal cases, the legal burden is on the Minister (at the criminal standard)

Settlements

- In ordinary civil litigation, parties will typically consider the costs and risks of litigation and may, to minimize them, decide to settle their case before trial.
- **Question:** is this also the case in tax litigation?
    - **Answer:** "yes" - but not to the same extent as in general litigation (so some say "no")
    - Technically speaking, both the CRA and Justice are under a **statutory obligation to assess tax in accordance with the acts and the current law.** This is commonly referred to as a "principled settlement" (or the "principled approach" to settling tax disputes)
    - Unlike other litigation, it is not possible to seattle on a "risk of litigation" or other basis that doesn't reflect and apply to the relevant current tax law to the facts
    - That said, the Minister does have the ability to "assume facts" so in practice, many cases are settled by the parties agreeing on the relevant facts - and then applying the law to those "assumed facts"

Unit #5 - The Mechanics of Income Taxation

Overview

- As we discussed in Unit #3, the starting point for the taxation of Canadian residents is **subsection 2(1)**, which states that "an income tax shall be paid, as required by the *Act*, on the **taxable income** for each **taxation year** of every **person resident in Canada** at any time in the year."
    - In Unit #3, we addressed two of the key components of this important section, (1) **who** is a **person** for Canadian income tax purposes, and (2) **when** is that person **resident** in Canada.
    - In this unit, we will discuss (1) **What** is "taxable income", (2) **How** Canada taxes such income when earned by an individual, and (3) **When** does that taxable income have to be calculated and reported.

What is Taxable Income

- **Subsection 2(2)** defines "taxable income" as "the taxpayer's income for the year plus the additions and minus the deductions permitted by Division C."
- **Subsection 248(1)** further provides that **"taxable income" cannot be less than nil**

Step #1 - Calculation of Net Income for Tax Purposes

- The starting point for calculating a Canadian resident individual's tax liability is to calculate her/his **Net Income for Tax Purposes** as specified in Division B of the Act.*
    - *technically section 3 refers to "income" rather than "net income" - but the calculator of "income" under the Act is a net calculation. The CRA refers to "net income" rather than "income" in its publications.
- As referred to in **section 3**, there are **four main sources of income**: Employment, Business, Property, Capital Gain/Loss.
    - There are other **miscellaneous income inclusions and deductions that are distinct from the other four sources -** which collectively are often referred to as income from the **"other"** source - so **five sources** in total.

To calculate **Net Income for Tax Purposes**, a taxpayer must perform the following four steps:

- **(1)** pursuant to **paragraph 3(a)**, calculates his/her income from employment, business, property, and other sources, as applicable, using the relevant rules for each applicable source - and then total the **positive and nil amounts.**

- Notes:
    - These calculations are done distinctly for each source/activity (**section 4**). A taxpayer cannot use a deductible business expense to reduce his/her employment income - or at least not at this stage of calculations.
    - As we will discuss in later Units, the rules for calculating income for each source are somewhat different - which creates tax preferences and opportunities for tax planning .
    - This is a "net" calculation - "taxable revenues" less "deductible expenses". (Sprysak's terms)
    - **Capital gains/losses are not included in this first step.**
    - As noted above, only **positive net amounts** are aggregated at this step of the calculation - so if a calculation of taxable revenue less deductible expenses for a particular source of income (ie. business income) results in a negative number, then a **nil amount is recorded for purposes of this step.**
    - In the case of **other sources**, only income inclusions are considered in this step.
    - After completion of this step, the **taxpayer will either have a positive or nil income balance.**

- **(2)** pursuant to **paragraph 3(b)**, a taxpayer then calculates the amount by which his/her **taxable capital gains** exceed **allowable capital losses**, as well as the taxpayer's net **listed personal property** gains.
    - While we will discuss **capital gains/losses** (and **listed personal property**) in a subsequent Unit in more detail, as we have already discussed:
        - A **capital gain/loss** arises from the (actual or deemed) disposition of capital property, and
        - Generally speaking, only **50% of capital gains** are **taxable** and only **50% of capital losses** are **deductible** for income tax purposes - with the other 50% being outside the scope of the Act (ie. non-taxable/deductible)
        - When the **inclusion rate** is applied to a **capital gain/loss**, it is referred to as a **"taxable capital gain"** and **"allowable capital loss"**
            - In contracts, if a document (or question) refers to a capital gain or loss, this refers to the entire capital gain/loss - including the non-taxable portion
        - **"Allowable capital loss"** that cannot be used in the year incurred **can be carried back or carried forward** to **offset a taxable capital gain** in a prior or subsequent year. When an **allowable capital loss** is carried back/forward, it is referred to in the Act as a **"net capital loss".**
    - Analogous to the first step, if the net amount is negative (ie. the taxpayer's **allowable capital losses** exceed the **taxable capital gains,** and/or there is a net loss from listed personal property dispositions), **a nil amount is reported for this step**

- **(3)** pursuant to **paragraph 3(c),** the **positive amounts** calculated in the first two steps are **aggregated** and then any **applicable deductions** contained in the **other source** (ie. moving and childcare expenses, RRSP contributions, etc.) are claimed.

- **(4)** pursuant to **paragraph 3(d)**, and employment, business, property, and **allowable business investment losses (ABILs)*** (but not **allowable capital losses****) that were calculated, but not reported earlier in this process, are deducted, **but only to bring the taxpayer's Net Income balance to nil.**
    - ***a "business investment loss" is defined in **paragraph 39(1)(c)** as generally the loss from the disposition of shares of a "small business corporation" or from debt issued by the small business corporation that has become uncollectible.
    - **this is due to the fact that **allowable capital losses** can only offset **taxable capital gains**

<u>Example of the Calculation of Net Income for Tax Purposes (step #1)</u>

- George's predominant source of income is from his employment with the City of St. Albert, where he works as a Senior Manager. For 2019, he earned a $150,000 salary (pre-tax) and his only deductible employment expense is Union Dues of $2,000.
- In addition to being an excellent administrator, George is also an incredible handyman. Up until 2019, he only did work on his own home and as favours (no charge). However, in 2019, he decided to start a small home repair/renovation business - which he thought he would like to carry on once he retired from the City in 2020. To get the "word out", he hired an IT programmer to develop a web page and purchased advertising on benches at bus stops in St. Albert. He also rented a small workshop close to his house and purchased several tools and equipment. His total deductible business expenses for 2019 are $40,000; the associated taxable revenue is $10,000.
- In 2019, George earned $25,000 of taxable investment (property) income, he incurred $5,000 of deductible interest expense associated with his income.
- 2019, George sold his shares in Apple and Petro Canada; he realized a taxable capital gain of $10,000 on the former and an allowable capital loss of $15,000 on the latter
- 2019, he received a taxable spousal support from his ex-wife of $12,000 and made a deductible Registered Retirement Savings Plan (RRSP) of $20,000 (both of theses amounts are part of the Other source of income)

What is Georges Net Income for tax purposes for 2019?

- Step 1: calculate positive net income from: employment, business, property, other
- Calculate income on a source by source basis

Employment: $150,000 - $2,000 = $148,000
Business: $10,000 - $40,000 = 0 (can't put negative amount here yet)
Property: $25,000 - $5,000 = $20,000
Other: $12,000
Total net income = $180,000

- Step 2: calculate positive capital gains

Apple = $10,000
Petro = ($15,000)
Total = 0 (can't use this negative yet)

- Step 3: combine the calculated amounts from the first two steps and claim any available deductions from other sources

Net Income for tax purposes: $180,000
Gains/losses: $0
Other deductions (RRSP): ($20,000)
Total = $160,000

- Step 4: Claim any employment, business, and property losses (and ABILs) incurred in the year - but only to bring the net income to Nil (at the least)

Net income from step 3: $160,000
Business loss: ($30,000)
Total = $130,000

<u>Step #2 - Calculation of Taxable Income</u>

- To calculate an individual's **Taxable Income, section 110** requires the taxpayer to take his/her **Net Income for Tax Purposes** calculated in step #1 and reduce it, as applicable, by the amounts contained in Division C, which includes: (list not comprehensive)
  - An amount in respect of **employee stock options** (pursuant to **paragraph 110(1)(d), (d.01) and (d.1))**
  - An amount for **"payments"** - most commonly, <u>workers compensation</u> and <u>social assistance</u> payments
  - Any **lifetime capital gains deductions** claimed under **section 110.6**
  - Any **loss carry overs** from other taxation years

<u>Step #3 - Calculation of Taxes Payable</u>

- Once **Taxable Income** has been calculated, then the next step is to calculate **Taxes Payable.** This is generally accomplished by multiplying **Taxable Income** by the appropriate **Tax Rate(s),** and then reducing that amount by any applicable tax credits.

Taxation Rate Regimes

- There are essentially 3 different **taxation rate regimes** that a gov't can adopt: **proportional, progressive** and **regressive**
- **Proportional Taxation** - tax regime where the **rate of taxation does not change as income changes**. B/c of this defining feature, it is often referred to as a "flat tax".
  - Alberta used to have this type of regime (excluding the application of tax credits) - by levying a 10% provincial tax on taxable income (as calculated under the Act)
- **Progressive Taxation** - a progressive tax regime is one where the **taxpayer's tax rate increases with his/her income.**
  - Our Federal tax regime has always been progressive - and since Oct 1, 2015, Alberta's provincial tax regime has become progressive
  - In the case of individuals, progressivity is accomplished by first allocating the taxpayer's Taxable Income into the various Federal (and provincial/territorial) brackets and applying the applicable rate to each bracket of income.
  - For **2020**, the **5 Federal** brackets and rates (which are adjusted annually for inflation) are as follows:

Income	Rate
$0 - $48,535	15%
$48,536 - $97,069	20.5%
$97,070- $150,473	26%
$150,474 - $214,368	29%
$214,369 +	33%

For **2020**, the **5 Alberta** brackets and rates (which are not adjusted annually for inflation) are as follows:

Income	Rate
$0 - $131,220	10%
$131,221 - $157,464	12%
$157,465 - $209,952	13%
$209,953 - $314,928	14%
$314,929 +	15%

Combining the **Federal** brackets and rates with the **Alberta** brackets and rates, in order to calculate the combined tax liability of an Alberta resident (excluding the application of applicable tax credits) - and rounding the brackets for ease of use - results in the following rate schedule:

Income	Federal Rate	Alberta Rate	Combined Rate
$0 - $50,000	15%	10%	25%
$50,001 - $100,000	20.5%	10%	30.5%
$100,001 - $130,000	26%	10%	36%
$130,001 - $150,000	26%	12%	38%
$150,001 - $210,000	29%	13%	42%
$210,001 - $315,000	33%	14%	47%
$315,001+	33%	15%	48%

Note: in practice, a Canadian resident will file two income tax returns - a Federal and provincial/territorial return - using the rate regime applicable to each return. For our purposes, Sprysak combined the rates to determine an Alberta resident's total tax liability (excluding the application of applicable tax credits)

<u>Step #3 - Calculation of Taxes Payable - Continued</u>

- **Question:** what would Georges combined (Federal and Alberta) tax liability be (before applying relevant tax credits)? Taxable income = $130,000
    - $50,000 x 25% = $12,500
    - $50,001 x 30.5% = $15,250
    - $30,000 x 36% = $10,800
    - Total = $38,550

- **Question:** if the gov't wished to generate the same amount of tax revenue from George using a proportionate tax regime, what would the rate have to be?
    - Tax rate would need to be 38,550/130,000 = 29.65%

Progressive Tax Terminology

- **Marginal Tax Rate**: the rate at which incremental income will be taxed
  - When considering the after-tax implications of earning more taxable income, the highest applicable marginal tax rate should be used.
- **Average Tax Rate:** this is calculated by taking total taxes payable and dividing it by totally taxable income.
- **Effective Tax Rate:** this is calculated by taking total taxes payable and dividing it by total **net** income. (for accounting purposes or for financial statement purposes)

Taxation Regimes Continued

- **Regressive Taxation** - a regressive taxation regime is one whether taxpayers pay tax at a lower rate as their income increases
  - Example: first $50,000 of income is taxable at a rate of 25%; any taxable income in excess of $50,000 will be taxed at a rate of 10%
  - PST is considered regressive to income in theory (b/c lower income earners who are not saving money are paying more PST compared to their income)

Question: why might a particular government/country choose one regime over another?

- **Proponents of a progressive tax regime** justify this approach (generally, compared to a proportionate tax regime) on the following grounds:
  - It better rectifies the inequality and unfairness (and luck) of the market economy than a proportionate tax regime (redistributive justice argument)
  - It better accords with a taxpayer's "ability to pay" taxes
  - It allows a gov't to reduce the tax rate on lower amounts of income by increasing the tax rate on higher amounts of taxable income
- **Proponents of a proportionate (or flat) tax regime** justify this approach (generally compared to a progressive tax regime) on the following grounds:
  - It does not put a disproportionate burden for taxes on a small higher income group - which may be seen to be unfair
  - Proportionate taxation also performs a redistributive function - although not as severe as a progressive rate regime
  - Progressive taxation might discourage work effort, risk taking, and savings.
  - Progressive taxation also encourages "income splitting" and "tax deferral strategies", which the gov't must then address with anti-income splitting and deferral legislation (which is inefficient)
  - Progressive taxation is more complex (ie. several tax rates/brackets as opposed to one)
- **Proponents of regressive taxation** justify this regime (generally compared to both proportionate and progressive regimes) on the following grounds:
  - It encourages economic growth (compared to both progressive and proportionate tax regimes)
  - It may better reflect income demographics (ie. vast majority of the population has income at roughly the same level, with a very small upper class)

Question: Are horizontal and vertical equity achieved by any of these regimes?

<u>Step #4 - Calculation/Application of Tax Credits</u>

- The final step in calculating an individual taxpayer's net tax liability is:
  - (1) to determine what tax credit(s) the individual qualifies for
    - The "personal" tax credits are contained in **subsection 118(1)**
  - (2) multiply the base amount(s) of the tax credit(s) by the applicable tax rate (which is typically the lowest marginal rate - 15% Federally and 10% for Alberta)
    - In the case of personal credits, the disability tax credit, and tax credits transferred from a spouse or person supported by a taxpayer, **section 188.91** further requires that they be prorated where an individual is resident in Canada for only part of the year
  - (3) take this calculated amount and use it to reduce the individual's tax liability calculated in Step #3
- **Important Point: Federal** tax credits can only be used to reduce an individual's **Federal** tax liability - and similarly, **Alberta** tax credits can only be used to reduce individual's **Alberta** tax liability

Some of the more common Federal tax credits are:

- **Basic Personal Credit (paragraph 118(1)(c))** - which can be claimed by a single person and has a **base amount for 2020, of 12,298***
    - *this tax credit (and many others) is indexed for inflation by virtue of **section 117.1**. Consequently, while the *Act* refers to $10,320 as being the amount of the tax credit (before being multiplied by the "appropriate percentage for the year"), the actual amount for 2020 (after applying the inflation factor) is 12,298 (see Tax Reference Tables at the front of the *Act*)
  - This effectively means that the first $12,298 of every Canadian resident taxpayer's income (regardless of his/her total taxable income) **is free from federal income tax**.
  - Of course, the actual tax savings is calculated as $12,298 * 15% = $1,844.70
  - **Note:** all of the provinces/territories have their own Basic Personal Credit - which can be used to reduce the amount of provincial/territorial taxes payable
  - In **Alberta,** this provincial Basic Personal Credit for 2020 is $19,369 - which (again) means that the first $19,369 of every Alberta resident taxpayer's income (regardless of his/her total taxable income) **is free from Alberta provincial income tax.**
  - Another way of quantifying this benefit is to take $19,369 * 10% = $1,936.90 - this is the reduction in an Alberta taxpayer's provincial tax liability (or tax savings)

- **Spousal/Common Law Partnership Credit (paragraph 118(1)(a))** - which provides that where an individual taxpayer is married or in a common law relationship, in addition to claiming the Basic Personal Credit for himself/herself. s/he can claim a credit for his/her spousal/CL partner.
  - The base amount of the Spousal Credit is generally the same as the Basic Personal Credit*, but is reduced by the spouse's CL partner's net income - hence once the spouse/partner has $12,298 of **Net Income**, the Federal Spousal Credit is no longer available
    - *if the spouse/partner is dependent on the taxpayer due to a physical or mental infirmity, the amount of the credit is higher
    - The spouse/CL partner is entitled to his/her own Basic Personal Credit
    - Only one person in the marriage/partnership can claim the Spousal Credit

- **Wholly Dependent Person Credit (paragraph 118(1)(b))** - which is available to a single person who is not claiming the Spousal Credit who supports a wholly dependent person who lives with the taxpayer, is related to the taxpayer, and who is wholly dependent on the taxpayer (ie. a minor child)

    - Like the Spousal Credit, the base amount of the Wholly Dependent Person credit is the same as the Basic Personal Credit (unless the dependent person is dependent b/c of a physical or mental infirmity - in which case the base amount is higher) but is reduced by the dependent person's net income

→ can only claim either spousal or wholly dependent credit

- **Age Tax Credit (subsection 118(2))** - which is available for individuals who turn 65 years of age before the end of the taxation year.
    - For 2020, the base amount of the Federal credit is $7,637, but is reduced by the individual's net income over a specified threshold

- **Canada Employment Tax Credit (subsection 118(10))** - which is available for all individuals who have employment income.
    - The base amount is $1,245 (unless the individual's employment income is less than this amount, in which case it is the individual's employment income)

- **Charitable Donation Tax Credit (section 118.1):**
    - This credit is unique in at least three respects
    - **(1) While the first $200 of charitable donations that are claimed in the year are multiplied by the lowest marginal rate** to determine the tax savings, **any donations in excess of $200 are multiplied by the 29% Federal rate** (unless the individual claiming the donation has income taxed at the 33% rate, in which that rate may be applicable).
        - Alberta has a somewhat similar regime - **the first $200 claimed is multiplied by 10% but any amount claimed over $200 is multiplied by 21%.**
        - This means that the combined Federal and Alberta tax relief for **charitable donations claimed in excess of $200 is 50% of the donation!**
    - Example #1 - Abby donates $100 to the Cancer Society and claims the donation on her 2020 tax return
        - Her Federal tax relief is $15 - calculated at $100 * 15%; her Alberta tax relief is $10 - calculated at $100 * 10%. Her combined tax relief is $25 on a $100 donation.
    - Example #2 - Betty donates $1,000 to the Arthritis Society and claims the donation on her 2020 tax return. She does not have any taxable income taxed at the 33% Federal tax bracket.
        - Her Federal tax relief is $200 * 15% = $262 plus $800 * 29%; her Alberta tax relief is $200 * 10% plus $800 * 21%. Her combined tax relief is $450 on a $1,000 donation.
    - **(2)** it is possible for charitable donations to be **carried forward for up to 5 years** before being claimed*
        - *in the case of ecological gifts, the carry forward period is 10 years.
    - **(3)** it is possible **for couples to pool their donations and claim them on one return**
    - Generally speaking, the limit on the amount of donations that can be claimed on a particular tax return (other than in the year of death) is 75% of the taxpayer's net income.

- **Medical Expense Tax Credit (section 118.2) -** which allows individuals to claim a credit for qualifying medical expenses over a specified threshold that have not been reimbursed by a health plan (unless the reimbursement must be included in the individual's income)
    - **Note:** b/c the credit is based on expenses over a specified threshold and that threshold is the lesser of a fixed amount ($2,397 for 2020) and 3% of the taxpayer's Net Income for the year, it is generally advantageous for the lower income spouse/partner to claim medical expenses for the couple/family.
    - Medical expenses tax credit depends on provincial legislation
    - Can claim all medical expenses of the family on one person's tax return (ie. parents and kids)

- **Disability Tax Credit (section 118.3) -** which allows a person with a physical and/or mental disability that satisfies all of the requirements in the Act (including certification by a listed medical practitioner) to claim a credit.
    - There is also a Registered Disability Savings Account that an individual can apply for (there are grants and a matching contributions option available) → need to qualify for disability tax credit in order to set up this account

- **Tuition Tax Credit (section 118.5) -** which allows students who incur eligible tuition fees to claim a Federal credit generally equal to 15% of those fees.
    - Like the Charitable Donation Tax Credit, there is a possibility of carrying forward this credit (**section 118.61**) when the student does not have sufficient income in the year the tuition fees are claimed to fully claim the tax benefit of the tax credit (although there is no maximum carry forward period).
    - Alternatively/additionally, where the student cannot fully utilize the tax credit, it is possible to transfer a portion of the credit to a spouse/CL partner (**Section 118.8**) and or a parent/grandparent (**section 188.9**)

Other Rules:

- Generally speaking to tax credits, the year that you qualify for those credits is the year you need to use those credits. If your total amount of credits after multiplied by the lowest marginal rate results in you having more tax credit then liability, that tax credit just disappears. Commonly referred to as tax credits being **non-refundable**.
- Another rule about tax credits is that the person who qualifies for claiming the tax credit, must be the person who claims that credit. Generally, tax credits are **non-transferable**.

<u>Tax Deductions vs Tax Credits</u>

- "Net Income" (or "profit") can generally be defined as "revenues" less "expenses" (or more generally, "net receipts").
    - While often attention is focused on the revenue/receipt side of this equation, equally important is the expense/cost side.
    - Generally, "deductions" are expenses that are recognized/allowed for income tax purposes.
    - They offset revenues/receipts and hence reduce a taxpayer's income (and taxes payable).
- Some deductions are "source-specific" - meaning that they can only be deducted in the calculation of one source of income (ie. the employment expenses listed in **section 8** can only be deducted against employment salary, wages and other remuneration as described in **sections 5-6**)
    - Other deductions are non-source specific, meaning they can be deducted against any source of income (ie. RRSP contributions)

- **Important Point:** as tax deductions reduce the income of a taxpayer, the benefit of a deduction is **taxpayer specific**

Example: let's assume that we have 2 taxpayers who each contribute $10,000 to his/her RRSP and as a result can claim a tax deduction for this contribution. The first taxpayer has $40,000 of taxable income before taking into account his RRSP contribution; the second taxpayer has $400,000 of taxable income before her RRSP contribution.

- **Question:** what is the value of the tax deduction to each taxpayer (ie. how much tax does the taxpayer save or, if tax has already been deducted as source, how much of a tax refund does the taxpayer receive)?
  - Formulae:
    - Taxable Income * Tax Rate = Taxes Payable
    - Taxes Payable without Deduction - Taxes Payable with Deduction = Tax Savings/Benefit
  - **For the $40,000 income taxpayer:**
    - Tax without RRSP contribution = $40,000 (taxable income) * 25% (tax rate) = $10,000 (Taxes Payable)
    - Tax with RRSP Contribution = $30,000 (income: $40,000 - $10,000 RRSP Deduction) * 25% = $7,500
    - Difference in Taxes Payable (Tax Savings/Benefit) = $10,000 - $7,500 = $2,500
  - **After tax income:** $40,000 * (1 - 25%) = $30,000
    - Use this calculation if you are looking to work overtime/take a part time job/start a business, etc. to see what the benefit would be

- **Question:** What does this "tax savings" really mean?
  - **Answer:** the person incurred a $10,000 expense (actually, contributed $10,000 to his RRSP) and, in the process, reduced his/her tax liability by $2,500.
  - Another way of saying this is that the gov't, through a reduction in the taxpayer's liability, contributed $2,500 to the taxpayer's expense/contribution, making the **net cost to the taxpayer $7,500 rather than $10,000**
  - **Important Point:** if an expense is deductible for tax purposes, then that **does not mean the item/expense is "free" to the taxpayer** - it simply means that for purposes of calculating taxable income and hence taxes payable, the item/expense will reduce taxable income and taxes payable.

- **Shortcut: Tax Deduction Amount * Applicable Marginal Rate = Tax Benefit/Savings**
- $10,000 RRSP Contribution * 25% Tax Rate = $2,500
- **For the $400,000 taxpayer:**
  - Shortcut calculation 10,000 * 48% Tax Rate = $4,800 tax savings

- Example: what if the taxpayer's Taxable Income before making the $10,000 RRSP contribution was $54,000. What is his/her tax savings?
  - **Answer:** $4,000 * 30.5% = **$1,220** plus $6,000 * 25% = **$1,500** equals a **total tax savings of $2,720**

Tax credits also constitute a tax benefit to taxpayers, but they provide the benefit to taxpayers in a different way than tax deductions.

- **Tax deductions** reduce a taxpayer's taxable income, which in turn reduces the taxpayer's tax liability (which is calculated by multiplying taxable income by the appropriate tax rates).

- In contracts, **tax credits** do not affect a taxpayer's taxable income. Instead, they are calculated separately from the calculation of taxable income (and taxes payable).

Important Point: B/c tax credits do not alter a taxpayer's income (and are generally calculated at the same rate for all taxpayers), **tax credits are not**, like tax deductions, **tax specific**; assuming that two taxpayers both qualify for the credit, they will receive the same "tax benefit" regardless of their income.

<u>Utilizing Tax Deductions and Tax Credits</u>

- If tax deductions exceed taxable revenues to create a net loss in respect of a particular source of income (or activity), then that loss:
    - In cases involving income from any source other than capital gains, the net loss may be used to offset net income from another source (or activity) in the current tax year (if any) - but only to bring net income for that year to nil, and
    - If the net loss cannot be used in the current year's return, it can be **carried back up to 3 taxactions years or carried forward** to offset taxable income in those tax returns (see **section 111**).
        - More specifically, if the loss is not a loss from the disposition of a capital asset, referred to as **"non-capital loss"**, then it can be **carried back up to 3 years and forward generally up to 20 years** and offset against **any source of income** in those years (**paragraph 111(1)(a)**)
        - However, if the loss is a loss from the disposition of a capital asset, referred to as a **"net capital loss"**, then the loss can still be c**arried back up to 3 taxation years and can be carried forward indefinitely** (ie. until the taxpayer dies), **but can only be used to offset net taxable capital gains in those years (paragraph 111(1)(b)).**
    - Given this feature, the tax benefit of a deduction will generally be realized - either in the year that it is claimed or in a prior or subsequent year.

- In contrast, for the majority of **tax credits, if they cannot be used in the current year to reduce an existing tax liability** (including a tax liability that has been covered by source withholdings or instalment payments during the taxation year), **then they are of no use for that taxation year (and are not applicable against future or prior taxation years)**
    - More simply, the benefit is lost (forever)
    - For this reason, tax credits are generally described as being **"non-refundable"**
    - That said, there are some exceptions where tax credits can be used by someone other than the taxpayer (ie. tuition tax credits) or carried forward to a subsequent year (ie. student loan interest)

- A few tax credits are als **"refundable"**, meaning they can result in a tax benefit even if the taxpayer is not taxable (ie. the GST credit).

<u>When Does Taxable Income Have to be Calculated and Reported?</u>

- **Section 249** and **249.1** collectively define the "taxation year" for each of the three "persons" recognized by the Act.
    - For an **individual**, generally speaking, the taxation year is the **calendar year** (January 1 to December 31)*
        - *As noted in **paragraph 249(1)(c)**, the calendar year is the default taxation year for anyone other than a corporation and a graduated rate estate.

        - As **trusts** are generally treated and taxed as if they are "individuals" pursuant to **subsection 104(2),** the default rule for trusts is that, like individuals, they will have a calendar year taxation year.
        - In the case of a **graduated rate estate (GRE)**, the current rule is that the taxation year cannot end more than 12 months after the testator's death and can be off-calendar, but only for 36 months, at which point it will be forced to have a calendar year taxation year.
- For a **corporation**, the taxation year is its **"fiscal period"**, which generally cannot end more than 53 weeks from when the period began.
    - Effectively, this allows a corporation to choose whatever 365 day period as its "fiscal period" - although once it selects this period, then generally speaking it is "stuck" with it unless it has a "good reason" to change it (ie. amalgamated with another corporation)
    - **Notes:**
        - In the corporation's first year of existence, it can have a fiscal period that is less than 365 days (which is typically the case to allow the corporation to select its fiscal year end)
        - This can be an important issue (for both tax and non-tax purposes) that should be addressed with the corporation's management, accountants and tax advisors (and perhaps creditors) to determine the best year end.

Practice Point: There are other provisions (ie. individuals carrying on a business, etc.) for which different reporting rules may apply. To be safe consult a tax professional to confirm that these other rules do not apply (or how to best use them).

Unit #6 - Employment Income

Overview of the Taxation of Employment

- The taxation of employment income is very important for two primary reasons:
    - (1) more tax revenue is derived from the taxation of employment income than any other source taxed by the ITA; and
    - (2) each individual who earns employment income also typically has a vote - so the government has to be very careful how it taxes employment income as this could impact its ability to stay in power
- Given this, it seems somewhat surprising (at least to me) that there are only 4 main sections that cover the calculation employment income - **sections 5-8**

Characterizing the Relationship b/t a Service Provider and Service Recipient for Income Tax Purposes

- When an individual provides **services** to another person and generates revenues and/or incurs expenses, for tax purposes, it is important to first consider the **capacity** in which the person is providing those services.
    - This will determine how the person's **income** from providing those services will be taxed under the Act, if at all
    - This can also have non-tax implications (ie. vicarious liability, need to comply with employment legislation (or not), etc.)
- Practically speaking, there are **three possible relationships for income tax purposes** that can exist b/t a service provider and a service recipient, namely: **a personal** relationship, and **employment** relationship, or a **business** relationship

    - For our purposes, a "personal relationship" (my term) is one that done with no intention for profit (ie. shovelling my neighbour's sidewalk after shovelling my own)
- In this context, when a **business relationship** is found to exist, the service provider is commonly described as an **independent contractor**
- Unfortunately, the Act doesn't contain very helpful definitions which could be used to distinguish b/t employment and business relationships. Looking in **subsection 248(1)**:
    - **Employed** - means performing the duties of an office or employment
    - **Employee** - includes officer
    - **Employer** - in relation to an officer, means the person from whom the officer receives the officer's remuneration
    - **Employment** - means the position of an individual in the *service* of some other person...and "**servent**" and "**employee**" mean a person holding such position
    - **Office -** means the position of an individual entitling the individual to a fixed or ascertainable stipend or remuneration and includes a judicial office, the office of a minister of the Crown, the office of a member of the Senate or House of Commons of Canada… and also includes the position of a corporate director, and **officer** means a person holding such officer
    - **Business** - is defined as "including a profession, calling, trade, manufacture or undertaking of any kind whatever and … an adventure in the nature of trade, but does not include an office or employment."
- **Note:** an activity will either constitute employment, a business, or a hobby (personal activity) for tax purposes; these characterizations are mutually-exclusive.

Overview of the Tax and Non-Tax Implications of Being in an Employment or Business Relationship

- **Commitment to Ongoing Costs (or not):** typically (but of course not always), an employment relationship is ongoing - and often indefinite. Consequently, deciding to employ someone (from the employer's perspective) is a significant commitment.
    - In contracts, business relationships are typically (but of course not always) established to acquire (from the service recipient's perspective) a particular service. Once that service has been provided/received, typically the business relationship is over - but, of course, may result in future relationships/contracts.
    - **From a service recipient's perspective, this non-tax implication is a key reason for wanting to structure its relationships as business relationships - to reduce/minimize its ongoing costs and commitments**

- **Scope of Deductions:** There is a different approach in how the Act is drafted to allow the deduction of expenses in calculating employment and business income
    - An **employee is very limited in the deductions** that s/he can claim - confined to those set out in **section 8**
        - The general rule for employment deductions is set out in **subsection 8(2)**, which provides that **unless a deduction is specifically allowed by section 8** (and the employee meets all of the requirements to be eligible to claim the deduction), **no deduction is allowed**
    - If an individual is running a **business,** then s/he has a **broader spectrum of expenses** that s/he can claim
        - The general rule for business and property deductions is set out in **paragraph 18(1)(a)**, which provides that if the **expense was incurred for the purpose of earning business income, it will be deductible for tax purposes** (unless another specific section denies the deduction).

    - **From a service provider's perspective, this tax implication is a key reason for wanting to structure its relationships as business relationships - to maximize the number of expenses that can be deducted in calculating business income for tax purposes.**

- **Employment Insurance (EI):**
    - If there is an **employment relationship**, then both the employee and employer will generally be subject to **employment insurance premiums** (or possibly the employer will pay both)*
        - *see generally sections 5, 67, and 68 of the *Employment Insurance Act*, SC 1996
    - However, if the service provider is an **independent contractor**, then the service recipient will not have to pay EI premiums in respect of the service provider (so a benefit to the service recipient - reduces service costs).
        - If the service provider is an independent contractor and s/he loses/ends her/his contract with the service recipient, then the independent contractor will not receive EI while s/he looks for new work (while an employee will often, but not always, be entitled to some EI support)
        - **Important point:** this is how many of these cases come before the CRA (and the courts) - the service provider losses their work with the service recipient, then goes looking for EI coverage.

- **Canada Pension Plan (CPP):**
    - Similar to EI legislation, if there is an **employment relationship**,then generally speaking **both the employer and the employee will have to pay CPP premiums.***
        - *see generally sections 6, 8 and 9 of the *Canada Pension Plan*

- **Vicarious Liability:** the basic rule/principle under tort law is that an employer may be vicariously liable for the acts of its employees but will not be vicariously liable for the acts of independent contractors

- **Payment and Withholding of tax:** not a huge issue to most employers as it is more of an administrative function and/or matter of timing/cash flow, rather than an addition cost or savings.
    - For employment income, the employer has the responsibility of withholding and remitting source deductions from employment income (**paragraph 153(1)(a))**
        - Many provinces (but not currently Alberta) also levy payroll taxes against employee remuneration.
    - In contrast, generally speaking, there are no withholding requirements associated with business income (although the service provider, like all businesses, might be required to make instalment payments)

- **Basis of Measurement: subsection 5(1)** requires employment income to be reported by employees on a **cash received basis**. In contracts, business income is generally calculated on an **accrual basis**.

- **Participation in Employer Plans/Benefits:** while employees (after passing their probationary period) are generally entitled to supplementary health care benefits and participation in the employer's pension plan (if such benefits/plans exist), independent contractors are not.
    - This may shift costs from the service recipient to the service provider (although it may be incorporated into the service provider's fee)

Determining the Characterization of a Service Provider for Income Tax Purposes

- The key case continues to be ***Wiebe Door Services Ltd. v Minister of National Revenue*** [1986](FCA) - which was approved by the SCC in ***671122 Ontario Ltd. v Sagaz Industries Canada Inc.*** [2001](SCR)
  - **Facts:** Wiebe Door Services Ltd. (WDS) was in the business of installing and repairing doors (primarily garage doors) in Calgary. Rather than having a large staff of installers (which of course would be costly - particularly when WDS didn't have work for them), WSD had contracts with a number of door installers and repairers, each of whom had the understanding that they would be running their own business with all of its implications (ie. no unemployment insurance, responsible for WCB premiums, taxes, etc.)
  - **Issue:** were these door installers and repair persons employees or independent contractors for tax purposes?
  - **Analysis: basic test/rule - you look at the whole relationship of the parties to determine if the service providers is in business for himself/herself or an employee of the service recipient (ie. his/her employer)***
    - *in the *Sagaz Industries* case, Justice Major, on behalf of the Supreme Court, states the question (para 47) in this way, "The central question is whether the person has been engaged to perform the services is performing them as a person in business on his own account".
    - Another way of asking the question often used by the courts - is there a contract **of service** (ie. an employment relationship) or a contract **for services** (ie. a business relationship)?
  - To answer this question, one must do a **comprehensive factual analysis** which considers all aspects of the parties' relationship.
  - In the course of performing this comprehensive analysis, one should consider the following **four tests** (but of course, not limit oneself to solely these tests), namely, the **control test**, the **ownership of tools test**, the **chance of profit and risk of loss test** (sometimes referred to as the **entrepreneurial test**) and the **integration test**.
  - Of course, while you address the four sub-tests in your analysis, in the end, **these tests must be considered together (along with any other relevant facts) to determine the essence of the relationship**
  - As noted by Justice MacGuigan, speaking for the FCA, at para 15 (and quoting from Professor Atiyah's test *Vicarious Liability in the Law of Torts*):

    What must always remain of the essence is the **search for the total relationship of the parties**… it is exceedingly doubtful whether the search for a formula in the nature of a single test for identifying a contract of service any longer serves a useful purpose… The most that can profitability be done **is to examine all the possible factors which have been referred to in these cases as bearing on the nature of the relationship b/t the parties concerned. Clearly not all of these factors will be relevant in all cases, or have the same weight in all cases. Equally clearly no magic formula can be propounded for determining which factors should, in any given case, be treated as the determining ones** [Emphasis added]

- **Practical Tip:** in applying these tests (or formulating arguments/positions in respect of each test), I find it helpful to have particular business and employment relationships in mind and then test your argument/position against these undisputed relationships
  - No single test is determinative

<u>Control Test</u>

- as a general rule, the **less control the payor can exert over the service provider, the more likely the relationship is a business relationship.** Conversely, the more control that the service recipient can exercise over the service provider, the more likely the relationship is an employment relationship (ie. "master-servant")
    - In applying this test, some judges have stated that if the payor controls only **what** is to be done, then this is more indicative of a **business relationship**.
        - **Example:** a client retains a lawyer to implement a real estate conveyance. The client (hopefully) does not tell the lawyer how to do the work.
    - Conversely, if the payor not only controls **what** is to be done but also **how** it is to be done, then this is more indicative of an **employment relationship**
        - **Example:** an in-house corporate counsel lawyer. The lawyer is likely subject to more supervision by his/her superiors than where a client retains a lawyer
    - **Note:** sometimes this test is not very helpful as the **terms of business contract** may, by necessity (or desire), be more detailed than would be necessary than in an employment relationship (in other words, the relationship contains a very high level of control on the part of the service recipient over the service provider).
    - In other cases, this test breaks down in cases involving very professional and/or technically skilled employees - where the employer is not really capable of controlling how the employee performs the work
        - **Note:** this does not mean that highly-skilled service providers cannot be employees - McDavid is an employee of the Oilers - but perhaps the control is exercised in different ways (ie. when Conor must show up to practice, whether he plays centre or wing, whether he is out on the power play or killing penalties, etc.)
    - One of the indica that some judges have found helpful in applying this test (but of course, not the only) is **whether the service provider must do the work herself/himself or whether s/he can subcontract/delegate it to another person**
        - If the service provider can hire helpers or someone else to do the job, then the courts have often found this fact to make the relationship look more like a business one
        - Good example: a client contracting for legal services with a law firm - don't necessarily expect the interviewing lawyer/partner to do all of the work (although in some cases, the client might demand just that)
        - That said, just b/c the service provider **must** perform the services does not mean that s/he is an employee of the service recipient (ie. like to use a particular hairdresser in a salon/barber shop)
    - Another factor that courts often consider is whether the **services are more "indefinite" in nature (ie. ongoing)** as compared to accomplishing a **"specific result"** - with the former generally (but not always) more indicative of an **employment relationship** and the latter *sometimes* more indicative of a **business relationship**
    - Other factors that courts have considered under this test include: mode and timing of payment, mandatory attendance at staff meetings, workers having to follow company policies, etc.

<u>Ownership of Tools Test</u>

- if the taxpayer owns all of the tools required to provide the contracted services, then this is typically viewed as more indicative of a business relationship
    - Least important test

<u>Chance of Profit/Risk of Loss Test (Entrepreneurial Test)</u>

- as the title indicates, this test explores whether the taxpayer has **the opportunity to profit** and the **risk of loss** - which are generally thought to be two of the hallmarks of a business
  - Of course, this test is more than its literal interpretation - employees "profit" through their remuneration, otherwise they would not likely continue to be employees.
  - What this test is often getting at is that, generally speaking, many employees make the same amount (per hour, per month) regardless of their performance (at least in the short term). As such, the chance of profit (other than perhaps a year-end bonus) or the risk of loss is low compared to a business person, who can have a much better or worse year depending on his/her efforts, the market, clients acquired and lost, etc.
  - This indicia also acknowledges the fact that generally speaking, employees only offer their time and expertise to the relationship, whereas businesspersons often have to invest in assets/equipment to be able to provide their services - and are at risk of not getting a reasonable return on those assets (but this starts to overlap with the ownership of tools test)
  - **Important Point:** showing how the service provider has a chance of profit and risk of loss is a key strategic issue for counsel

<u>Integration Test</u>

- this test is to be applied **from the service provider's standpoint** (rather than the service recipient's standpoint) and **asks whether the service recipient is so integral to the provider's business that the activity would likely end/fail if the recipient ceased to be a customer/client**
  - If the existence of the recipient is not critical to the provider's business (ie. just one of several clients/customers), then this will be an indica supporting characterization as a business relationship
  - This is sometimes described as the **"economic dependence"** test

The Role of the Parties' Intention in Characterizing their Relationship

- Question: Do the parties' **(mutual) intention to create an employment or business relationship**, as set out in a jointly signed written contract, play any role in the characterization of a service relationship?
  - **"Old School Traditional Answer":** In *Wiebe Door*, the FCA state that the parties' intention that the installers "would be running their own businesses...was not determinative of the relationship b/t the parties and a court must carefully examine the facts in order to come to its own conclusion."
  - However, the FCA in ***13926444 Ontario Inc. v Minister of National Revenue*, 2013 FCA (Connor Homes)** (among other recent decisions) has taken a different view of the role of the parties' intention. More specifically, it (at least arguably) expands the analysis set out in *Wiebe Door* (and *Sagaz*) as follows:
    - **Step #1 -** consider "whether there is a mutual understanding or common intention b/t the parties regarding their relationship" (*Connor Homes*)
      - As noted at para 39, this can be ascertained "either by the written contractual relationship the parties have entered into or by the actual behavior of each party, such as invoices for services rendered, registration for GST purposes and income tax filings as an independent contractor."
    - **Step #2 -** where such a mutual intent (typically to have a business relationship) exists, consider "the relevant factors in light of that mutual intent for the purpose of determining if, on balance, the relevant facts support and are consistent with the common intent." (*Connor Homes)*

    - **Important Point:** The parties' mutual intention is **not legally determinative.** If present, then their mutual intention only creates a "prism" through which the *Wiebe Door* analysis is to be undertaken
        - **Relevant question:** is the particular component of the relationship being considered **inconsistent** with the parties' mutual intention (as identified/verified in Step #1)?
        - If not, then the parties' relationship (and the service provider's income) for tax purposes should be characterized in accordance with their mutual intention

Incorporated Employees

- **Question**: assuming that after performing a *Wiebe Door* analysis, as supplemented by *Connor Homes*, your professional opinion/conclusion is that an employment relationship has been created by the parties, is it possible to change this characterization for income tax purposes by having the service provider incorporate a company, who will then contract with and provide services to the service recipient?
    - **Note:** in the Act, the individual actually providing the services now as an employee of his/her corporation is referred to as an "incorporated employee"
    - **Answer:** No - it doesn't work for tax purposes
- To combat this (inappropriate) form of tax planning, in 1981, the federal government created the definition of a **"personal services business"** in **subsection 125(7)**, which has following three characteristics:
    - (1) A **service** business carried on by a **corporation** where,
    - (2) The individual who provides the services on behalf of the corporation (the "incorporated employee") or anyone related to the individual, is a **"specified shareholder"** of the corporation, AND
        - "Specified shareholder" is defined in **subsection 248(1)** generally as person who owns "not less than 10% of the issued shares of any class of the capital stock of the corporation"
    - (3) The incorporated employee would reasonably be considered an employee of the service recipient but for the existence of the corporation, UNLESS
        - The corporation employs in its business throughout the year **more than 5 full-time employees** (or one other exception - n/a for the course) - will not be found to be carrying on a personal service business
        - Courts have interpreted this exception strictly, you must legitimately NEED and USE more than 5 employees full-time to carry on your services
        - Case law says you need at least 5 full time and then possibly a part time person (does not have to be 6 full time)

- Briefly, if a corporation is found to be carrying on a "personal services business", then the 2 most significant (and taxpayer unfriendly) consequences are:
    - (1) The income from such business is **not eligible for the small business deduction (and other rate reductions)** - meaning that it is taxed at full corporate rates (b/c income from a personal services business is not "active business income" as defined in **subsection 125(7)**), which are similar to personal rates, and
        - Indeed, an additional corporate tax is levied on personal services business income by **section 123.5**
    - (2) By virtue of **paragraph 18(1)(p)**, the corporation is severely restricted in what expenses it can deduct for tax purposes in calculating its personal services business income (to essentially what an employee could deduct under **section 8**)
    - More simply - there are no tax advantages to incorporating a corporation to carry on a "personal services business"; indeed, there are additional costs, including the potential for double tax (once the

income is distributed to the shareholder/employee) compared to simply earning the income personally and non-tax costs of creating and maintaining another legal entity.*
    - *See *Gomez Consulting Ltd. v The Queen* 2013 TCC, for a case involving an IT worker whose corporation was found to be carrying on a personal services business (with the CRA as a client)

<u>What is Included in Employment Income?</u>

- Starting for determining what is to be included in employment income for income tax purposes is **section 5.**
  - While a very short section, it answers 2 important questions, namely:
    - **What** is to be included in employment income for tax purposes (tax base question)?
    - **When** such income is to be calculated/included (timing question)?
- With respect to the 1st question, **subsection 5(1)** generally provides that a taxpayer's income from an office or employment is the **salary, wages**, and **other remuneration, including gratuities, received** by the taxpayer during the year.
    - Consequently, gratuities (as just one example) flowing from a customer to the employee still constitutes employment income and must be included.
  - See **subsections 6(3) and (3.1)**, which supplement **section 5** by deeming certain payments to fall within the scope of **section 5** (ie. an inducement payment or signing bonus to become an employee is employment income for tax purposes even though the payment(s) happen prior to the employment commencing)
  - **Practice Point:** these sections (and **paragraph 6(1)(a)** below) lead me to my "rule of thumb" that if an amount/benefit is received by an individual that has *some* connection to his/her employment, to assume that it is taxable as employment income (or a taxable employment benefit) until you convince yourself otherwise
- With respect to the 2nd question, **subsection 5(1)** provides that the **recognition event** for tax purposes is **receipt** during the year.
  - Not surprisingly, this is commonly referred to as the **"cash basis"** of income recognition - you report your employment income in the taxation year in which it is **received**, as opposed to when the work is done (which is the general basis for recognizing business revenue).
  - So, for instance, if any employee (or a group) is working without a contract and then receives a lump sum payment to account for a retroactive pay increase, that payment will be taxed in the year the payment is received (rather than having to amend prior year's return when the work was possibly done)

Taxable Benefits - Sections 6

- **Section 6** (arguably) expands what is taxable under **section 5** by explicitly providing that benefits connected to the employment relationship are also generally taxable as employment income.
  - The primary provision in **section 6** is **paragraph 6(1)(a)**, which requires an employee to include in his/her employment income "the value of board, lodging *and other benefits of any kind whatever received or enjoyed by the taxpayer* or by a person who does not deal at arm's length with the taxpayer, in the year *in respect of, in the course of, or by virtue of the taxpayer's officer or employment*"
  - Typically, this provision is applied to catch "non-cash benefits", (as cash benefits would likely be caught by **section 5**)
  - **Paragraph 6(1)(b)** supplements **6(1)(a)** by generally providing that any allowances received for **personal or living expenses** are also taxable as employment income (with some legislative exceptions)

- Generally, for **paragraph 6(1)(a)** to be engaged, the employee must **(1)** receive or enjoy a "benefit", **(2)** "in respect of, in the course of, or by virtue of the taxpayer's officer or employment" (collectively - an "employment benefit") that is **not excluded** by (a) the Act, or (b) the jurisprudence.

- **Question:** what is an "employment benefit" for tax purposes?
  - **Answer:** Professor Krishna has defined it (and this definition has been accepted by the courts) "as an economic advantage or material acquisition, measured in monetary terms, that one confers on an employee in his capacity as an employee".

- **Question:** When is a benefit "in respect of, in the course of, or by virtue of" employment?
  - **Answer:** The leading case concerning the relationship b/t a benefit and an individual's employment continues to be ***R. v Savage*** [1983] 2 SCR 428, in which case the Court referred to its decision in ***Nowegijick v The Queen*** [1983] 1 SCR 29 at para 30, where it stated that:

    > The words "in respect of" are, in my opinion, words of the widest possible scope. They import such meanings as "in relation to", "with reference to" or "in connection with". *The phrase "in respect of" [is] probably the widest of any expression intended to convey some connection b/t two related subject matters*.

  - As a result of this interpretation, generally speaking, courts don't have difficulty finding the necessary relationship b/t the benefit and the employment relationship.

A Brief Overview of Selected Statutory Taxable Benefits

- **Note:** as the taxation of these amounts are specifically detailed in the Act, they are taxed pursuant to the provisions discussed below, as opposed to pursuant to **paragraph 6(1)(a)**
  - **Paragraph 6(1)(a)** operates to tax other employment benefits not specifically addressed in the Act

- **Imputed Interest Benefit:** where an **employer makes a loan to an employee**, then the general rule under **sections 6(9) and 80.4** is that the employee has to report a **taxable benefit equal to the amount of the loan multiplied by the excess of the prescribed rate over the rate charged by the employer, less any payments made by the employee to the employer in respect of the loan** in this year or within 30 days of the following year
  - If the employer forgive the loan, then **subsection 6(15)** deems the amount of the forgiven loan to be a taxable benefit in the year forgiven
  - Prescribed rate - set by CRA

- **Automobile Benefits:**
  - **Subsection 6(2) and paragraph 6(1)(k)** describe the **standby*** and **operating**** benefits that an employee may have to report on his/her tax return when an **employer provides the employee with a vehicle that the employee uses for personal purposes.**
    - *****this benefit relaties to simply having access to the company vehicle and is based on the value of the vehicle and the number of complete months that the vehicle is available to the employee.
    - **this benefit relates to the operation costs incurred by the employer in respect of the employee's personal travel and is generally calculated by multiplying the number of personal use kilometres by a prescribed rate (28 cents/km for 2020). If the employee pays all of the operating costs, then there will ot be a taxable operating benefit to the employee.

- **Personal trips** have generally been defined by the courts as home to work, work to home, and any personal travel that has no connection to work (ie. going from your home to the golf course).
- **Note:** where an employee uses the company vehicle solely for work trips, there is no taxable benefit to the employee.
- Further, to the extent that the employee pays the employer for the personal use of the vehicle in the year or within the first 45 days of the following year, this will reduce/eliminate the taxable employment benefit
- **Where the employee uses his/her own vehicle for work** (as well as personal purposes) and **his/her employer pays all of the operating costs**, then **paragraph 6(1)(l)** requires a taxable benefit to be reported (ie. personal kms divided by total kms driven multiplied by total costs paid by the employer)
- Finally, where an **employee use his/her own vehicle for work purposes, then the employer can pay the employee a "reasonable allowance" (ie. solely based on work kms) that will *not* constitute a taxable employment benefit.**
    - For 2020, the per km rates are 59 cents on the 1st 5,000 work kms and 53 cents thereafter.
- Different Scenarios for Vehicle Usage:
    - Scenario 1 - employer purchases the vehicle and pays for everything and then the employer provides the vehicle to the employee, and the employee would use the vehicle to carry out some of their work responsibilities but also for personal use
    - Senario 2 - where an employee uses their own vehicle for work and personal use and the employer pays for all of the operating costs related to the vehicle
    - Scenario 3 - difference b/t 2 and 3 is that in 3 the employer pays an allowance, and the allowance is based on the number of work km travelled

Taxable (and Non-Taxable) Allowances and Reimbursements

- Subject to a list of exceptions contained in the provision*, **paragraph 6(1)(b)** generally provides that **an employee has to report any allowances received from his/her employer as a taxable benefit**.
    - *****these non-taxable exceptions include "reasonable" allowance for travel (particularly where the employee sells property or negotiates contracts for his/her employer) and the use of the employee's motor vehicle (discussed above)
    - **Notes:** in some cases, an employee can mitigate this result by deducting the associated expense if allowed by **section 8**

- An **"allowance"** has generally been defined by the courts as an amount that the employee is paid, for which s/he does not have to substantiate how it was spent
    - B/c there is no accountability, the potential exists for the employee to pocket the money and/or use it for personal purposes and as such, increase his/her net worth
    - Typically provided before the expense is incurred (not always though ie. mileage)

- In contracts, if an employer **reimburses** an employee for a **work expense** (ie. an expense primarily for the employer's benefit), then that reimbursement will generally not constitute a taxable benefit since the employee is not better off.
    - However, if an employer **reimburses** a employee for a **personal expense**, then the employee has to report the amount as **taxable benefit** since s/he is better off
    - In contrast to an **"allowance",** a **"reimbursement"** is where the employee has to account to his/her employer before getting paid (ie. provide receipts of work expenditures).

        - Folio S2-F3-C2 para 2.16, defines a “reimbursement” as “a payment made to repay an amount an employee spent on a specific expense and for which detailed receipts are provided.”*
            - *this folio was withdrawn from the canada.ca website and it is stated that it is “currently under review”
- **Practice Point:** where commercially feasible/practicable, it is better (for tax purposes) to structure a system whereby employees are **reimbursed for work expenses** (rather than providing them with an allowance).

Statutory Exceptions

- Generally speaking, if an employee receives a benefit measurable in monetary terms that is connected to his/her employment relationship, then a prudent starting point is to assume that it constitutes a taxable employment benefit.
    - The next step is to consider whether there is a **statutory** or **common law exception** that would change the characterization to being a non-taxable benefit.
- As one might expect (given the existence of **paragraph 6(1)(a)**), there are not many benefits that an employer can provide to its employees that will not be taxable as a result of a statutory exclusion.
- That said, there are a limited number of cases contained in **section 6** where an employment benefit will not be taxable to the employee. Two of the more common statutory non-taxable benefits contained in **paragraph 6(1)(a)** include:
    - Benefits from counselling services in respect of the mental or physical health of the taxpayer (or an individual related to the taxpayer) or the re-employment or retirement of the taxpayer (**subparagraph 6(1)(a)(vi)**)
    - Education assistance to someone other than the taxpayer (ie. a child) if it is reasonable to conclude that the benefit is not a substitute for salary, wages or other remuneration of the taxpayer (**subparagraph 6(1)(a)(vi)**)

Common Law Exception

- The courts have developed a common law test called **“the primary beneficiary”** test to determine whether an employee has received or enjoyed a taxable employment benefit (see *Lowe v Canada (1996)*) This is a two-part test:
    - **(1)** did the item under review provide the employee with “an economic advantage that is measurable in monetary terms”?
        - If the answer is yes, then you go to the second question; if the answer is no, then the employee does not have a taxable benefit and the analysis is over.
    - **(2)** if an advantage was provided, who was the **primary beneficiary** - the employer or the employee?
        - The FCA has described this as an “all or nothing test”
        - If the answer is that the **employer** is the **primary beneficiary**, then the employee *will not have to report a taxable benefit* (even if the employee did benefit somewhat)
        - Conversely, if the answer is that the **employee** is the **primary beneficiary**, then the employee *will have to report the full value of the item as a taxable benefit* (even though the employer might also benefit)

Examples:

- **Parking:** if the employer provides free parking to an employee (for which there is otherwise a charge*), then the employee will generally be considered to be the primary beneficiary (and will have to report a taxable benefit) *unless* the employee is regularly required as part of his/her job to use his/her can (in which case it will be a non-taxable benefit as the employer will generally be held to be the primary beneficiary)
  - *if the parking lot is a free "scramble lot", then the first part of the test will not be satisfied (ie. no "economic advantage, measurable in monetary terms") and there is no taxable employment benefit.

- **Fitness memberships:** despite all of the health and productivity benefits to employees who exercise regularly, the courts have generally held that unless the employee's job has minimum physical requirements (ie. a police officer, fire fighter, etc.) the employee is the primary beneficiary of an employer-provided fitness membership (it will be a taxable employment benefit)

- **Continuing Education:** if the employer pays for the cost of an employee taking a course that is related to the employee's job responsibilities, then the courts have generally found the employer to be the primary beneficiary and, as such, the course is a non-taxable benefit to the employee.
  - Conversely, if the course is unrelated to the employee's work (ie. course on learning how to golf), then the courts have found the employee to be the primary beneficiary and hence a taxable benefit.

Practice Point: while the "primary beneficiary test" may seem quite straightforward in theory, its application can result in various outcomes depending upon the particular facts in issue (and the particular judge deciding the appeal)

- Some judges (and commentators) take the view that the primary beneficiary test is to be applied more "objectively" or "generically" - you consider the facts to determine <u>generally</u> who is the primary beneficiary of the expenditure.
- Other judges, particularly in more recent years, take the view that in addition to applying the test generically, you can also consider whether the particular taxpayer in the case "subjectively" enjoyed a benefit.

Unfortunately, the Federal Court of Appeal has added to the complexity of determining whether something is a taxable employment benefit under **paragraph 6(1)(a)** though its recent decision in *Smith v Canada* (2019).

- **Facts:** Mr. Smith lived in Calgary and worked as a flight attendant for Jazz Aviation. To assist Mr. Smith (and its other flight attendants) in getting to the airport on time, which is important to its business, Jazz provided its flight attendants with their own (paid) parking stall at the airport.
- **Issue:** is this a taxable benefit?
- While both the taxpayer and the Crown argued their positions based on the primary beneficiary test described above - and while the FCA acknowledge that the primary beneficiary test has a role in the analysis, in my reading of the decision, it appears that the FCA is moving away from the primary beneficiary test as a way of determining whether the employee should be taxed on the value of the benefit.
- More specifically:
  - The FCA begins its analysis by characterizing parking as an **inherently personal expense**
  - It also states (at para 38-39), that where an **employer pays/subsidizes a personal expense**, it will generally be a taxable benefit - since an employee's economic position is improved where his/her employee covers his/her "ordinary, everyday expenses".
  - The FCA seems to put more of the emphasis on the **type of expense** being covered by the employer rather than on who the primary beneficiary of the expense is.

    - In addition, the FCA states that the **overall/primary goal is to determine whether the employee has received something of economic value from his/her employer** - rather than to determine who the primary beneficiary of the expense is

<u>Administrative Exceptions</u>

- The CRA has had a longstanding practice of taking positions (and publishing - unfortunately, in a variety of different forms) what it feels to be non-taxable benefits outside of what has been pronounced by the courts in specific cases.
- Currently, it publishes its views in its **Employers' Guide: Taxable Benefits and Allowances** (T4130)

Valuation

- After determining that an employee has received or enjoyed a taxable employment benefit, the next step is to **value that benefit** to determine the income inclusion.
    - **Practice Point:** generally speaking, the Act does not specify how to do this, which has resulted in some uncertainty and diversity in the case law.
- **Example:** in lieu of paying faculty and support staff "cost of living" increases, suppose that the University offers (and all staff accept) to provide free educational services (ie. tuition) for any children of current employees.
    - **Question:** assuming that the primary beneficiaries of this program are the University staff members, how might you value it?
    - **Answer:** possibilities include: (1) the FMV tuition cost, (2) the incremental cost to the University, (3) the average cost of a University degree across Canada, etc..

<u>Employment Deductions</u>

- **Starting Point: subsection 8(2)** provides that unless the deduction is specifically provided for in this section (or another section in the Act), an employee cannot claim a deduction in calculating his/her employment income.
- Some of the common deductions in **section 8** include:
    - **Legal expenses (paragraph 8(1)(b)):** where the legal expenses were incurred to obtain an amount that, if received, **would be reported as employment income for tax purposes** (ie. lost wages in a wrongful dismissal case).
        - If the amount of damages includes an amount that would be taxed as taxable income for the claimant, then those legal expenses are deductible
        - If its legal expenses for something like a divoirce, these expenses are NOT deductible
    - **Sales expenses (paragraph 8(1)(f)):** includes non-capital expenditures (ie. travel expenses and motor vehicle expenses) incurred by employees who earn **commissions.**
    - **Travel expenses (paragraph 8(1)(h)):** available to all employee who:
        - Ordinarily carry on their employment duties away from the employer's place of business. And
        - Were required under their employment contract to pay these expenses
    - **Dues and other expenses of performing duties (paragraph 8(1)(i)):** which would include the following expenses - as long as they were not reimbursed (or the subject of an allowance) by the employer:
        - **Annual professional membership dues** the payment of which was necessary to maintain a professional status recognized by statute
        - **Officer rent or salary to an assistant,** the payment of which...and which the employee was required by the contract of employment to pay

        - The **cost of supplies that were consumed directly in the performance of the employment duties** - and for which the employee was required by the contract of employment to pay
    - **Motor vehicle costs (paragraph 8(1)(j)):** this would include "tax depreciation" (which is referred to as "capital cost allowance" (CCA)) and interest costs pro-rated for the employee's work use
    - **Home office expenses (subsection 8(13)):** to claim an expense for a home office, the work space must either be
        - The place where the employee principally (ie. more than 50%) performs his/her employment duties, or
        - Used exclusively for the purpose of earning employment income and used on a regular or continuous basis for meeting customers or other persons in the ordinary course of performing his/her employment duties.
        - Further, the deduction can only be **non-capital expenses** (ie. a proportionate amount of rent, utilities, etc. but not such expenses as mortgage interest, property taxes, or insurance - unless the employee is a commissioned salesperson) and cannot exceed the employment income that is generated by the home office - with the ability to carry forward any excess expenses.

- **Caution:** as indicated above, for several of these expenses, in order for them to be deductible, in addition to the employee being required to incur them as part of his/her employment, the employer must fill out a certificate (T2200 - Declaration of COnditions of Employment) as per **subsection 8(10)** which the employee must include in his/her tax return in order to get a deduction.

Working from Home due to COVID-19

- COVID-19 has resulted in the vast majority of employees having to work for at least part of the year at home. In many cases, employees and employers have incurred a variety of costs associated with this mandated (and unexpected change.
- Focusing on employees, **common tax questions** include:
    - What, if any, "work expenses" might I be able to deduct for income tax purposes?
    - What, if any, "home office expenses" might I be able to deduct for income tax purposes?
    - Assuming that I am able to deduct expenses, how do I go about doing this in accordance with the Act?
- General comments:
    - In order for any expenses to potentially be deductible by an employee, as we have previously discussed, they must be work-related. Personal expenses are not a deductible employment expense.
    - The work expense must also be borne by the employee. If they are reimbursed by the employer, then those expenses will not be deductible by the employee (since s/he has not actually incurred an expense).
- As noted above, for several of the possible deductible expenses, the provision requires that it be a condition of employment that the employee incur the expense and/or maintain (and work from) a home office - an the Act further requires the employer to confirm this through the completion of a T2200 - Declaration of Conditions of Employment.
    - With respect to the "condition of employment" requirement, the CRA has stated in the past that it may not be necessary in all cases that an explicit term be contained in the employee's written employment contract - that in some cases, this condition may be inferred.
    - With respect to the T2200 requirement, while tax practitioners have (on multiple occasions) asked the CRA to waive this requirement this year as literally hundreds of thousands of employees could

potentially be claiming employment expenses requiring T2200's to date, the CRA has stated that a T2200 is required, though they have amended the form to simplify it.

- With respect to the home office deduction:
  - It is unclear in the 1st situation whether the condition that employee principally perform his/her employment duties at home be measured on an annual basis or during a period in the year.
  - It is also unclear whether this 1st condition would be satisfied if the employee was required/forced to work principally at home (ie. the employer's office was closed) vs whether the employee chose to work principally at home (but had the option to go to the employer's worksite).
  - With respect to the 2nd condition, it is unclear whether "meeting customers and or other persons…" would be satisfied where the employee conducts online (ie. Zoom) meetings from his/her home computer.

- With respect to an employer reimbursing an employee for equipment that the employee purchases (and owns) that may be used for work purposes (ie. a computer), the CRA's longstanding policy has been that the employee is still the primary beneficiary (as s/he owns the equipment and may use it for non-work purposes) and hence the reimbursement constitutes a taxable benefit.
  - However, with respect to reimbursements of expenses relating to computers and home office equipment (ie. desks, chairs, etc.) purchased as a result of COVID-19 (and the requirement to work at home), the CRA has stated that it will consider up to $500 per employee to be a non-taxable benefit (assuming that it was a reimbursement with the employee providing with his/her employment with receipts)
  - However, if the employer simply provided the employee with a $500 allowance - with no requirement to account for how that money was spent (and the requirement to return any unspent monies), it would be considered a taxable benefit.