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Closer Encounters with the CRA

In last month's article – "Close Encounters with the CRA" – I talked about some recent developments pertaining to CanRev. This month, I would like to continue on the same theme, but this time around, with more of a focus on what could be increasingly draconian strategies on the part of the CRA in an effort to bring in much-needed tax revenue.

Self-Assess Or Else – Or Else What?

Just after last month's article came out, one of our readers asked a couple of interesting questions about the CRA's "self-review" letters I discussed in the article. First question: If a taxpayer gets a CRA letter, will he or she be eligible to make a voluntary disclosure, or would this be disallowed by the CRA on the grounds that the taxpayer is already under review? While it is not categorical, the February 4th CRA release pertaining to the self-review letter initiative seems to suggest that a self-review letter will not preclude a voluntary disclosure, indicating that the CRA wishes to "provide taxpayers the opportunity to amend their income tax returns by completing an adjustment request and/or by making a voluntary disclosure in cases where the taxpayer may have claimed deductions in error or provided inaccurate information".[1]

The reader also asks: If the taxpayer is reassessed down the road on an item contained in a letter, will the client immediately be hit with a gross negligence penalty? For what it's worth, I think that if it turns out that the taxpayer has no proper basis for the claim, the fact that it has been brought to the taxpayer's attention by the CRA without a response would help to provide the basis for contending that he or she is deliberately disregarding the tax rules.[2]

Inside

Lipson Aftermath

Just over a year ago, I wrote an article on the effect of the Supreme Court of Canada decision in the *Lipson* case on personal tax planning.[3] A *Lipson*-type strategy could be used, for example, to make mortgage interest deductible, as well as to achieve asset protection. Although the tax rules brought into play in *Lipson* have a certain degree of sophistication, the *Lipson* fact situation itself couldn't be simpler: Wife borrows to buy shares[4] from husband, which are flipped over to wife on a tax-deferred basis – in my view, that's the simple kernel of *Lipson*. Ignoring GAAR for the moment, because the shares roll over to the wife, the attribution rules trip in, leaving the interest deductible by the husband.

In *Lipson*, the taxpayer was GAARed on the basis of a misuse of the attribution rules, with the result that the husband could not deduct the interest expense.[5] Trouble is, you can't "GAAR yourself" – the CRA must do this. So if you are in the *Lipson* situation, how would you file – in view of the fact that the highest court in the land has nixed the transaction (albeit, in a split decision)?

This question was put to the CRA at the 2009 APFF Financial Round Table;[6] an English translation of the answer was released a few days ago. The CRA indicates that, in a *Lipson* replay, the individual and his spouse would be taking part in transactions that have already been "deemed abusive" by the Supreme Court of Canada. The CRA indicates that, in the circumstances, it "might consider" applying the 50% "gross negligence" penalty. In addition, the application of third-party civil penalties might be considered.

While I can't say that the CRA's answer is wrong in the technical sense, the fact situation that could get a taxpayer into a *Lipson*-type situation is very simple and straightforward – so much so that one could unwittingly stumble into it.[7] So how do you avoid the CRA's hellfire and brimstone, for example, if a *Lipson*-style flip was done before the Supreme Court of Canada verdict came out? Unfortunately, the CRA doesn't really answer the APFF's question – i.e., how do you file a return if you can't GAAR yourself? Alternatives were canvassed in my article last year. For example, one possibility is to take the position that the subsection 75.5(11) anti-avoidance rule applies, so that both the income or gain on the transferred asset itself, as well as interest on the indebtedness in question, would be taxable/deductible to the transferee-spouse.[8] Another alternative is to take the position that *Lipson* does not apply, e.g., perhaps the strategy was structured on a different basis or was undertaken for non-tax reasons. However, in view of the CRA's harsh statements, this alternative should be considered very carefully.[9]

What if the transferor opts-out of the spousal rollover – e.g., wife borrows to buy the shares or other appreciated property, but husband flips the property to the spouse on a taxable basis, so that there is a deemed sale of the property at fair market value? The CRA's view is that this situation differs from *Lipson*. The transferee-spouse could deduct the interest on the borrowing made to acquire the shares, to the extent that the normal tax conditions relating to interest deductibility are met.[10] Of course, paying tax on a transfer may not be desirable; however, if the deferred tax exposure is modest or non-existent, or the capital gains exemption is available to shelter the gain, this may not be a bad move.

Ten Years After

As I noted, the CRA says it might invoke the third-party civil penalties in the case of a *Lipson* replay. The same topic caught my eye earlier last month in a CRA release pertaining to "shady" tax preparers and promoters.[11] The release notes that, since the civil penalties legislation was introduced close to a decade ago, close to 100 third-party penalty audits are either in progress or have been completed.

Frankly, I am surprised that the number is that high.[12] Although these penalties attracted a lot of fuss when they first came out – including from the author – in recent years relatively little has been written about them. At the time, my guesstimate was that it would be about a decade before the program started to get a full head of steam.

While it has been stated that the CRA would apply the civil penalties only where there has been egregious con-

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duct,[13] my prediction, based in part on the CRA news release I mentioned earlier, is that as the decade goes on, the imposition of these penalties will become at least somewhat more common. (For example, one area which has been cited for the application of these penalties could be where the tax preparer becomes "complicit" in his or her client's hiding income offshore.[14]) Whether they will proliferate, like the director's joint-and-several-liability penalties,[15] which were also supposed to be used sparingly, remains to be seen. Hopefully, "egregious" means "egregious" – like claiming fake charitables – not a big business use on a car. But I find the APFF statement a bit troubling, especially if the way forward isn't clear.

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Notes:

[1] Generally, the CRA indicates that a disclosure may not qualify as a voluntary disclosure if it is found to have been made with the knowledge of an audit, investigation or other enforcement action. A sample self-review letter indicates that "The CRA *may* be conducting audits in your sector of activity. A *preliminary review* of your income tax and benefit return has indicated . . .". Hopefully, the wording is deliberate. The letter also specifically refers to the voluntary disclosure program, impliedly, at least, as a way of responding to the self-review letter. I would hope that if the receipt of the self-review letter would result in a taxpayer being ineligible to participate in the VDP program, there would be no mention of it in the letter itself.

[2] Generally, the CRA has stated that a taxpayer's history of compliance and knowledge of tax matters will be relevant in the assessment of subsection 163(2) penalties.

[3] "Personal Tax Planning – Spousal Flips and Income-Splitting Loans", TAX NOTES No. 553, February 2009.

[4] Or other assets that have deferred tax exposure.

[5] In *Lipson* itself, the result of the application of GAAR was that the transferee-spouse must claim the interest deduction. However, the transferor-spouse would presumably continue to report dividends and gains from the transferred shares themselves.

[6] Round Table on the Taxation of Financial Strategies in Instruments – 2009 APFF Conference, Question 12. In another question (23 of the original version of the Round Table), the CRA indicated that the transfer of unrealized losses between spouses, per the application of the superficial loss rules, as described (for example) in Doc. No. 2003-0017075 (May 27, 2003), would not be adversely affected by *Lipson*.

[7] To me, the essence of the *Lipson* strategy involves the transferee-spouse becoming indebted in order to acquire a previously unlevered asset, transferred on a rollover basis, so that the transferor-spouse claims the interest deductions pursuant to the attribution rules. Unless the subsection 74.5(11) anti-avoidance provision applies, there is no alternative to this treatment – i.e., the transferor cannot elect out of the attribution rules. The same result may apply, for example, if the transferee-spouse assumes the transferor's indebtedness as consideration for the transfer, or the transferor takes back an interest-bearing note: I find it difficult to distinguish these situations from *Lipson*. The APFF question itself did not delineate any specific variations along these lines other than the question indicating that the individual applies "the exact strategy of Mr. Lipson". However, the CRA focused on the fact that the individual transferred the shares to his spouse without making the fair market value election, so as to invoke the attribution rules. Besides obtaining a tax benefit, these types of transactions may be recommended in order to achieve asset protection objectives, since it is important that, if assets are transferred to a spouse or other family member, the transferor should receive "good consideration".

[8] As pointed out in the article, this, of course, could prejudice previous filing positions.

[9] It is not clear that the CRA's comments pertain to transactions undertaken prior to the Supreme Court's decision. The APFF question is: "We would like to know what the CRA's current position would be in a situation where a taxpayer proceeds, in 2009, with transactions similar to those carried out by Mr. Lipson and analyzed by the Supreme Court of Canada in January 2009 . . . The individual applies the exact strategy of Mr. Lipson and lets the rules of subsection 73(1) of the ITA apply to the transfer of the shares. Given that a taxpayer cannot, on his own initiative, apply the general anti-avoidance rule (GAAR) to himself when filing his tax returns, how should the individual and his spouse file their tax returns . . . ?"

[10] The conditions of subsection 74.5(1) must be met. Besides opting out of the subsection 73(1) rollover, the requirements of paragraphs (a) and (b) re adequate consideration must be met.

[11] "Minister Ashfield assures Canadians that shady tax preparers and promoters will be penalized", March 16, 2010.

[12] It seems that most of these files must have arisen fairly recently. At the 2005 Canada Tax Foundation Conference, the CRA indicated that, as of August 31st, 2005, 13 cases had been considered for the application for the civil penalties. Six were currently under audit and two had been approved for the application of the penalties.

[13] See Information Circular IC 01-1, September 18, 2001.

[14] For example, if the client decides not to go forward with a voluntary disclosure of offshore income and wants to carry on with the offshore account; see "Current Issues" 2009 BCC 1, Frank W. Quo Vadis. Don't dismiss the possibility of these penalties springing from actions related to the self-review letters I discussed earlier, especially if the dollar amount is large.

[15] Respectively, sections 227.1 and 160 of the *Income Tax Act*.

Payroll Changes Re Stock Options

On March 10, 2010, the CRA posted a notice on its payroll site that "effective March 4, 2010, there are new rules for the treatment of employee stock options". The notice stated that after March 4, 2010, an employee may not defer the stock option benefit and that the CRA will release further information at a later date. This notice is pursuant to the changes proposed in Resolutions 25 to 31 of the 2010 federal Budget.

Bill C-9, *Jobs and Economic Growth Act* Receives First Reading

Bill C-9, *An Act to implement certain provisions of the budget tabled in Parliament on March 4, 2010 and other measures* (short title *Jobs and Economic Growth Act*), received first reading on March 29, 2010. Among other things, this Bill contains the tax measures from the Notice of Ways and Means Motion released on March 22, 2010 relating to certain 2010 Budget proposals, including the amendment to the definition of "taxable Canadian property" discussed in this week's lead article, above. The Department of Finance has not yet released explanatory notes for the tax provisions in the Notice of Ways and

Means Motion. When the explanatory notes become available, CCH will send a Special Report, with the legislation and notes, to subscribers of the CANADA INCOME TAX GUIDE (print, DVD and online).

Charities Directorate Re Budget Proposals

On March 31, 2010, the CRA's Charities Directorate announced that it is acting to respond to the proposed changes in the March 4, 2010 federal Budget that affect charities i.e., the changes to disbursement quota calculation and proposed measures regarding the expenditure of amounts on charitable activities – see Budget Resolutions 18 to 22. Due to these proposed changes for taxation years of charities that end on or after March 4, 2010, the Charities Directorate is making changes to form T3010B, "Registered Charities Information Return". Until these changes are reflected, the CRA will include instructions with the T3010B package being mailed to charities, starting in April 2010.

CRA's SR&ED Claim Review Manual

On April 1, 2010, the CRA announced that on May 1, 2010, the CRA's Research and Technology Advisors would begin using the Claim Review Manual for the review of SR&ED claims. According to the announcement, the new Claim Review Manual will provide the CRA's advisors "more detailed procedures and background information on planning reviews; coordinating reviews with Financial Reviewers; conducting reviews and working with claimants during the review process; concluding and reporting on review results; and documenting reviews". The CRA stated that the Claim Review Manual is consistent with the eight steps set out in the current "Guide to Conducting a Scientific Research and Experimental Development Review". This guide is reproduced in the Canadian Tax Reporter online under CRA Publications, Scientific Research and Experimental Development, Guides. See chapter 2 of this guide for the eight steps of the SR&ED Review Process. The Guide is to be revised so that it will be a short version of the CRA's Claim Review Manual. A draft version of the revised guide is to be posted by the CRA in late April, for stakeholder input.

Prescribed Interest Rates – Second Quarter of 2010

The prescribed interest rates for the second quarter of 2010 are unchanged from the first quarter and are noted below:

- 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 3% on refunds of income tax overpayments; and
- 5% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from April 1, 2010 to June 30, 2010. The table at ¶12,745 has been updated accordingly.

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