

THE Quarterly Dividend

Vol. 26 No. 2 Your guide to income tax & financial planning

FAST TRACK



The Art of Persuasion

Think of how often you need the co-operation of others to get things accomplished in life. But how do you go about enlisting their involvement? It will depend on the relationship between you and the other party, how you relate to each other and the environment where

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Here's What to Expect in the Months Ahead

Most Canadians file their personal income tax returns on time containing information they believe to be as accurate as possible. They "settle up" with the government by claiming a refund of overpaid taxes or remit an amount owing if that is required. Either way they then feel relieved that this annual chore is now behind them.

Unfortunately, the Canada Revenue Agency does not share this sentiment. It has turned the filing of personal income taxes into a year-round process where they will take the next eight months or longer to scrutinize your submission and ask you to defend the claims you made on the form.

Here is what you can expect in the weeks and months ahead:

Prior to April 30: File your personal income tax return, reporting income earned during the year and all deductions to which you feel entitled resulting in an "amount owing" which you send in to the tax authorities or a refund that you expect will arrive as quickly as possible;

Prior to June 15: Receive your Notice of Assessment from the Agency essentially agreeing with your original submission either accepting the amount of money you remitted along with your return when it was filed or sending you the refund that you claimed;

Prior to September 30: Receive a letter from the Agency indicating that "as part of their on-going review" of the way Canadians file their income tax returns, your particular income tax report has been selected for examination because (a) you claimed one of the following deductions this taxation year: (i) charitable donations, (ii) medical expenses, (iii) child related expenditures such as child care or childrens' arts or fitness activities, (iv) RRSP's, (v) moving expenses, (vi) etc. , etc.

Or (b) failed to report certain investment or other income items on the form.

You have thirty days to produce documentation that your deduction claims were valid and send it to the government or explain why the income inclusion they have highlighted should not have been there (and wasn't) when the return was filed.

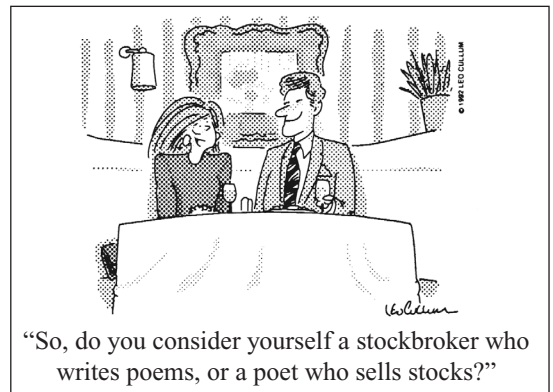
If these receipts or explanations are not received by the date they have been "requested", the Canada Revenue Agency will amend your return to deny your deduction or include the income items they feel are warranted.

Post September 30: Comply with the CRA demands for the additional information they want and await their determination whether the documentation submitted will be agreeable to them. If the answer is "yes" then your return will be accepted as filed and hopefully that will be the end of the process for you this year.

If the answer is "no" and the government disallows your deduction claim or includes additional income on which they want to impose tax, then you have to decide whether or not to "fight" the re-assessment or just accept their decision.

A lot of the decision-making will centre around the amounts of money involved and/or whether you can make a "good case" that your original filing was accurate and the government has made a mistake.

But that is a subject for another article.



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Sticker Shock

the request/proposal will be initiated and where it will be carried out. Business relationships are different from those between family members and relationships with third parties are different once again. Finally there is the issue as to whether the request or proposal is a "one time" occurrence or whether you will need the on-going co-operation over some period of time.

Here are a few approaches to consider when enlisting the help of others:

- (a) **apprising** - explain how carrying out a request or supporting a proposal will benefit him personally;
- (b) **coalition** - seek the aid or support of others to enlist his support;
- (c) **collaboration** - provide him with as many resources and assistance as possible to encourage his

Jack filed his 2016 personal income tax on April 28, 2017, just before the filing deadline. He figured he would take an "aggressive" approach this time around and that by submitting his form at the end of the filing period, his return would slip through the cracks and not be scrutinized by the CRA who would inundated with forms at that time.

The table below summarizes what Jack sent in. You will note that he claimed four deductions from income and four "non-refundable" tax credits leading to an anticipated tax refund of \$8112.

At first everything appeared to have gone according to plan. As noted in an accompanying article, the CRA did their initial examination of the return and determined that it looked okay. They issued the refund cheque in the amount that was claimed and Jack believed that he had beaten the system.

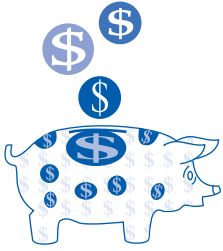
About a month later, Jack received correspondence from the Agency asking him to substantiate his deductions and credits. He complied as best he could even though he knew that he would not be able to satisfy the auditor on every point.

As you can see from the table, the auditor accepted the T4, the medical expenses and the amount Jack paid for public transit. The other items were either dismissed out of hand or adjusted downward.

Jack now has "sticker shock". He did not know that the inflated claims would affect his income tax return to the tune of \$5500. Otherwise he might not have chosen to be quite so "aggressive". Now he must repay the money that he had been advanced by the Agency and incur interest charges until it is paid off.



		What Jack Declared \$	What CRA Accepted \$	Difference \$
T4 income	Employ income	100,000	100,000	
	CPP contrib	2,544	2,544	
	EI premium	955	955	
	I/T deducted at source	24,978	24,978	
Deductions	Union dues	1,000	240	760
	Moving expenses	5,400	NIL	5,400
	Employ expenses	7,812	2,400	5,412
	Legal/accting fees	565	NIL	565
				12,137
Non-refund credits	Public transit amount	1,300	1,300	
	Interest paid stud loan	450	NIL	4 50
	medical expenses	5,775	5,775	
	char donations	2,600	1,100	1,500
	Taxable income	85,223	97,360	12,137
	Non-ref tax credits	3,939	3,437	502
	I/T refund	8,112	2,612	5,500



participation; (d) **consultation** - encourage his participation in planning/setting up the activity for which his support and assistance are required;

(e) **exchange** - offer something of interest "down the road" if he will go along with your request today; (f) **inspirational appeal** - an appeal to his values/ideals to gain commitment to the current request/proposal;

(g) **ingratiation** - use praise and flattery before or during the influence attempt to get him "on side"; (h) **legitimizing** - establishing the legitimacy of the request/proposal through references to rules, practices, precedents and procedures;

(i) **organizational** - explain how the request/proposal will benefit the organization and the accomplishment of its objectives; (j) **personal appeal** - ask

What Constitutes a Valid Receipt?

An accompanying article mentions the occasional necessity of providing documentary evidence to the Canada Revenue Agency that a particular expense was incurred for income tax purposes. This makes it important to examine what separates an "acceptable" receipt from one that will be rejected out of hand by the CRA auditor.

At this stage, we are not talking about whether the expense itself will be allowed by the Agency. The provision of receipts for moving expenses, for example, may all prove beyond doubt that a taxpayer changed his residence during the year and moved from point A to point B. The claim might still be denied by the Agency if he did not qualify for the deduction due to other factors that precluded him from making the claim in the first place.

It is important to understand what separates a valid receipt from one that will not be accepted. In general terms, a proper receipt will (a) substantiate your claim that you did indeed incur the expense you are claiming, (b) validate your

claim as to the nature and timing of the expenditure, and (c) prove the dollar amount of the transaction in question.

In specific terms, an acceptable receipt will contain the following information, at a minimum: (i) the name and address of the party issuing the receipt (and their HST number, if applicable), (ii) the name and address of the party to whom the receipt is being issued, (iii) the date that receipt is being processed, (iv) a description as to what goods or services the recipient received from the issuer, and (v) the issuer's signature (can be preprinted on the document).

Sequential numbering of receipts is advised but not mandatory.

If the above information is included, the "unique identifier" of both the issuer and the recipient of the receipt cannot be questioned and the receipt can be considered "valid" for income tax purposes.



Transactions with Related Parties

When a taxpayer typically thinks about the Lifetime Capital Gain Exemption that applies to the disposition of shares of a qualified small business corporation or a qualified farm or fishing property, he rarely considers the identity of the individual with whom he is about to transact. But this becomes very important if the parties to the transaction are related to each other.

The Canadian *Income Tax Act* provides for two "general rules" regarding capital transactions.

The first is the general rule for the calculation of

General Properties

These general rules apply to transactions between parties who deal with each other at "arm's length".

When parties do not, the Act applies certain restrictions that must be considered. These can be summarized as follows: (1) when the property is acquired for an amount in excess of its fair market value, the Canada Revenue Agency will assume that the cost of the property was its fair market value. The actual price paid for the property will be "adjusted" down to its fair

market value or loss. It is determined as the difference between (1) the amount received as proceeds of disposition of the property in question and (2) the property's "adjusted cost base" plus any costs of disposing of the property.

The second is the general rule that stipulates (1) the "proceeds of disposition" is made up of the consideration paid to the seller and (2) the "adjusted cost base" of the property is the actual amount that was paid to acquire the property.

market value and (2) and when the taxpayer sells the property for lower than its fair market value, the CRA will once again assume the proceeds of disposition to be the fair market value and adjust the transaction upward.

From time to time, the Agency's determination of "fair market value" may be substantially different from that of the taxpayer. In those cases the Agency will ask him to justify his valuation before it will be accepted.



Corporate Shares

Another example when the actual proceeds of disposition received by the seller are set aside and replaced with another calculation involves the sale of shares of a corporation to a related party. In this case, what would have otherwise been a capital gain in the "normal" course of business, is regarded as a "return of capital" usually for a nominal amount and a "deemed dividend" for the remainder. The extra taxes are considerable.

See the following example.

Fact: Harvey is the sole shareholder of a corporation. He has two offers that he is considering. The first is from an "unrelated third party" with whom he does business. If he sells his shares to them, he will be entitled to the Lifetime Capital Gains Exemption. The second offer is from his son whom he has always wanted to succeed him in the business.

him to carry out a request or support a proposal as a personal favour in advance of telling him what it is;

(k) **pressure** - use demands, threats, persistent reminding to have him carry out request/proposal; and (l) **rational arguments** - emphasize factual evidence to show request/proposal is feasible and relevant

The use of these techniques either independently or in combination of several should foster co-operation between parties if applied with tact and respect for the other. Just remember to be gentle!!

Sale to:	Unrelated Third Party \$	Harvey's Son \$
Proceeds of disposition	500,000	500,000
Adjusted cost base	1,000	
Capital gain	499,000	
Paid-up capital		1,000
Deemed dividend		499,000
Taxable dividend		688,620
Income tax	22,074	
Income tax		215,283
Net amount realized on sale	476,926	284,717

Note: The "amount" of the deemed dividend is not necessarily the same as the capital gain, but in this case it is.

Conclusion: Harvey will realize significantly more "after tax" dollars if he sells the shares to an unrelated third party as compared with selling them to a family member or another individual with whom he does not deal at arm's length. In this case almost over \$200,000 more.

This makes it much more expensive for a family

business to be passed down from one generation to the next. A long while back, the Income Tax Act encouraged the inter-generational sale of companies by deferring the capital gain realized by the parent until it was realized in the second generation. But this was abandoned and replaced by these rules. If the promotion of the family business is something you feel to be important, you should encourage the government to change their policy in this area when the next budget is introduced.

Thanks for Your Referrals

We very much appreciate your referrals. If you know of someone who can benefit from the services we provide or who would like to receive our publication, please let us know. We will send them a copy with your compliments.

Determining If You Are Dealing at "Arm's Length"

There are some complicated rules in the Income Tax Act determining whether two taxpayers are dealing with each other at "arm's length". However, it is generally accepted that the following individuals are thought not to deal with each other at "arm's length" strictly due to the familial relationship that exists between them:

(a) one is a child of the other;

(b) they are brothers, sisters;

(c) they are married to each other or living common-law.

Beyond these, other factors come into play which make it necessary to look at each case on its merits.



The Quarterly Dividend highlights income tax and other financial matters in general terms. We recommend that no action be taken based solely on the basis of information contained in this letter. Specific professional advice should be obtained as individual circumstances must always be taken into account. This newsletter is copyright; its reproduction in whole or part by any means, without the written permission of the copyright holder, is forbidden.