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Tax Letter

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THE "FIRST-TIME" HOME BUYER'S CREDIT

Many taxpayers are unaware of a federal bonus available if you are buying a home and do not currently own one.

Section 118.05 of the *Income Tax Act* provides the "first-time home buyer's credit". You do not actually have to be a first-time buyer. Rather, you and your spouse (or common-law partner) must not have owned a home during the past 4 calendar years or in the current year.

Any home will qualify: detached house, semi-detached, townhouse, condominium unit, residential co-op share, or mobile home. You have to intend to live in the home as a "principal place of residence" within a year after acquiring it. The home need not be newly constructed.

For the year in which your purchase closes, you can claim a **federal credit of $750** against your federal income tax. This is claimed as an amount of $5,000 on Line 369 on Schedule 1 of your return. (It is then totalled with other amounts and multiplied by 15% to become part of your federal "non-refundable tax credits".)

You and your spouse (or common-law partner) can claim only one such credit between you. But either of you can claim the credit (no matter who takes title to the home), so if one of you does not have enough tax payable for the year for the credit to be useful, the other should claim the credit.

So if you are in the market to buy a home and have not recently owned one, you can budget for this $750 bonus!

For more information, see cra.gc.ca/hbtc

CAPITAL GAIN OR INCOME?

Since capital gains are only half taxed, the distinction between **capital gains** and **income** is very important.

Capital property is property on which any gain is taxed as a capital gain. Only half of a capital gain is included in income in your tax return — the "taxable capital gain". Thus, the effect is that capital gains are taxed at half the rate of ordinary income such as interest or employment income.

Not all gains are capital gains. If you are in the business of buying and selling goods — for example, operating a retail store — then obviously your gains from the goods you sell are business profits, which are fully taxable, and not capital gains.

Some types of gains fall close to the line. The *Income Tax Act* defines the term "business" — the income from which is fully taxable — as including an "adventure in the nature of trade". This phrase has been interpreted in hundreds of reported court cases.

If what you are doing is a "business" or an "adventure in the nature of trade", then your gain will be **fully taxable** as the sale of inventory. If it is not, then your gain will be only half taxed as a capital gain. On the flip side, business *losses* are fully deductible from income, while capital losses are only half-deductible and normally only against taxable capital gains.

So how do you determine the difference between capital property and inventory?

Basically it comes down to **intention.** If you buy a property with the intention of selling it, then you are considered to be in business and the gain will be fully taxed as business profit.

REAL ESTATE

The most difficult issues usually arise with respect to **real estate.** You might build a home to live in (capital), but also with plans to sell it (inventory). You might buy land on which to develop a shopping plaza to lease out (capital), or on which to develop a subdivision of new homes that you will sell (inventory).

The Canada Revenue Agency's Interpretation Bulletin IT-218R, "Profit, Capital Gains and Losses from the Sale of Real Estate" (available at cra.gc.ca) provides the Agency's views on whether the purchase and sale of real estate will be treated as leading to business profits or capital gains. Paragraph 3 of the Bulletin sets out twelve factors that the CRA considers relevant:

a. the taxpayer's intention with respect to the real estate at the time of its purchase;

b. feasibility of the taxpayer's intention;

c. geographical location and zoned use of the real estate acquired;

d. extent to which the taxpayer's intention is carried out;

e. evidence that the taxpayer's intention changed after purchase of the real estate;

f. the nature of the business, profession, calling or trade of the taxpayer and associates;

g. the extent to which borrowed money was used to finance the real estate acquisition and the terms of the financing, if any, arranged;

h. the length of time throughout which the real estate was held by the taxpayer;

i. the existence of persons other than the taxpayer who share interests in the real estate;

j. the nature of the occupation of the other persons referred to in (i) above as well as their stated intentions and courses of conduct;

k. factors which motivated the sale of the real estate;

l. evidence that the taxpayer and/or associates had dealt extensively in real estate.

In determining your intention with respect to the property, the Courts have also developed the concept of a **"secondary intention"**. If you have an intention of using the property as capital property, but a secondary intention of selling it if the main intention does not pan out, then the property may be considered to be inventory and the gain fully taxable. The CRA's Interpretation Bulletin IT-459 discusses this issue. Of course, just about everyone will sell their property if the right offer comes along, so the secondary intention has to be something more than just a willingness to sell if the price is right. There is often no clear dividing line, but the Federal Court of Appeal said in the 2008 *Canada Safeway* case that for there to be a secondary intention, it "must have been an operating motivation in the acquisition of the property".

PRINCIPAL RESIDENCE

The prospect of treating your principal residence (your home) as capital property is always attractive. Even better than the regular "half tax" treatment given to capital gains, the gain on a principal residence is normally **completely exempt** from tax.

However, if you are in the **construction business,** or if you change homes often, watch out! Many small home builders have tried building a home, moving in, then selling it and moving on to another home, repeating the process a few times. If you do this, the CRA will determine that you do not have an exempt capital gain after all. Instead, you are treating each home as **"inventory"** — even though you lived in it — and you will be fully taxed on the gain as business profit. And if you haven't kept all of your receipts for the costs of construction, you might have a hard time proving that your profit was less than the CRA claims it was!

(To make matters worse, if this happens you will also be required to pay GST or HST on the *entire value* of the new home, including the land, as of the date you moved in. As well, unless you have kept receipts showing GST/HST paid on construction costs, your offsetting input tax credits will likely be denied. Quite a number of small home builders have taken such assessments to the Tax Court of Canada and have lost, on both the GST and the principal residence issues.) Note that real estate records transfer are permanent and easily available to CRA auditors once they start looking, and in many cases there will be no statute of limitations — e.g. because your return had a misrepresentation attributable to "carelessness or neglect", or you didn't file a GST return. **The CRA has been known to go after builders even 10, 15 or 20 years after the fact** and assess them for tax, GST of HST, penalties and vast amounts

of interest that has accrued over the years. If you are in this situation, consider making a Voluntary Disclosure before the CRA comes calling.

SHARES

When it comes to **shares of corporations** and other securities, such as bonds and mutual fund units, the CRA generally accepts that most people hold such securities as capital property, even where the shares are junior stocks that are unlikely to pay a dividend any time soon. However, if you actively trade, buying and selling shares on a regular basis and holding them for only short periods, you might be found to be in business, so that your gains would be fully taxed. (If you have losses, this will be to your advantage.)

You can avoid this situation, with respect to shares in Canadian companies, by filing a "Canadian securities election" (subsection 39(4) of the *Income Tax Act*), on Form T123, with your tax return. Once you make this election, all Canadian securities you hold are deemed to be capital property, forever. (In other words, if you have losses from very active trading in a later year, those losses will be capital losses that have limited use, rather than business losses that you can deduct against other income.)

Note that the Canadian securities election does not apply to all Canadian shares. There is an exclusion for "prescribed shares", listed in section 6200 of the *Income Tax Regulations*. These include:

- private corporation shares whose value is primarily attributable to real property or resource property
- debt to a person or corporation with whom you do not (or did not) deal at arm's length
- shares or debt acquired from a person with whom you did not deal at arm's length (this would include shares you inherited from a deceased family member)
- exploration and development shares
- shares or debt substituted for any of the above.

COURT CASES — WHY ARE THEY IMPORTANT?

We regularly give you news about tax cases decided in the Courts. Why are they important?

First, you need to understand the legal basis on which our tax system operates. Tax is imposed by the *Income Tax Act*, which is legislation passed by Parliament (and amended every year). The Department of Finance proposes changes to the Act in the annual federal Budget and throughout the year, and drafts amendments to the legislation, but the changes do not become law until Parliament passes them.

When we have a majority government, it is almost a foregone conclusion that all proposals from Finance will be enacted. Even under a minority government, it is almost certain that technical amendments that are not politically charged will be enacted eventually, although this can take years. And when they are enacted, they are usually made retroactive to the date indicated when they are first announced.

But the *Income Tax Act* is very complex — about 2,000 pages of difficult and sometimes unintelligible language. It takes a lot of interpretation, and its application in many situations is unclear.

The Canada Revenue Agency publishes extensive materials to help us interpret the Act. Most of this material can be found on its Web site, at cra.gc.ca. CRA publications include Interpretation Bulletins, Information Circulars, Income Tax Folios, guides, pamphlets and other documents. These can be used by taxpayers and their advisers in deciding how the *Income Tax Act* will apply to any given situation. They are also used by CRA assessors, auditors and appeals officers in deciding how to assess or reassess taxpayers in any given situation.

However, the CRA **does not make the law**. As noted above, the law is made by Parliament. The CRA merely *interprets* the law. **Its interpretations are not legally binding.** There are many situations where taxpayers (and their advisors) disagree with CRA interpretations. (See the *Conocophillips* case discussed under "Around the Courts" below for an example.)

This is where the Courts come in. Any taxpayer who disagrees with an assessment or reassessment can file a Notice of Objection within 90 days of the date on the Notice of (Re)Assessment. For an individual, the deadline is the later of this 90-day period and one year after the filing-due date for the year in question. The matter is then considered by a CRA appeals officer; this is a purely admin-istrative process, very informal, with telephone discussions and correspondence but no formal hearing.

If after discussing the case with the taxpayer or the taxpayer's representative and reviewing their written submissions, the appeals officer believes that the assessment was correctly based on the rules in Income Tax Act, the appeals officer will "confirm" the assessment. Or the appeals officer may "vary" the assessment to reduce it, but perhaps not as much as the taxpayer would like.

At this point, a taxpayer who still wants the assessment changed has to go to Court. Appeals of income tax (and GST) assessments are filed in the **Tax Court of Canada.**

There is nothing wrong with appealing a case to the Tax Court. It will not cause the CRA to look at you as a "problem", nor will it result in extra audit attention to you in the future. If you genuinely have a good legal case, you should appeal. But you should consult a tax lawyer or other qualified professional to determine whether you do have a good case. Without expert advice it's very easy to go wrong in trying to interpret the Act.

The Tax Court of Canada is an excellent Court: well run, efficient, humane and friendly, especially to taxpayers who do not have a lawyer and are appealing a relatively modest amount of tax. Where the amount of *federal* tax and penalty does not exceed *$25,000* for each taxation year, an income tax appeal can be filed under the Tax Court's "Informal Procedure". (The same goes for a GST/HST appeal of up to $50,000.) The process is a formal Court hearing that follows the rules of Court, but the judge is able to bend the rules of evidence and to be more flexible in reaching his or her decision. At the end of the day, however, the decision must still be based on the rules in the *Income Tax Act*, and the Tax Court will not allow a taxpayer's appeal merely because the result is otherwise unfair. There has to be a **legal basis in the Act** for allowing the appeal.

For larger appeals, the Court's General Procedure is used. While human taxpayers are allowed to represent themselves, it is highly advisable to retain a tax litigation lawyer to deal with the procedures, which include formal pleadings, Lists of Documents, discoveries, Status Hearings and various other procedural steps, as well as organizing and presenting the evidence and making the correct legal arguments.

If you are not happy with the Tax Court's decision, you can appeal to the Federal Court of Appeal, but normally only on a question of law. Any findings of fact reached by the Tax Court are binding (unless you can show that no judge could reasonably have reached that conclusion based on the evidence presented — a "palpable and overriding error"). You are not normally allowed to bring any new evidence to the Federal Court of Appeal — the decision is based on the written record of the evidence at the Tax Court trial.

If you win at the Tax Court, the CRA can appeal to the Federal Court of Appeal, under the same rules as above.

From the Federal Court of Appeal, an appeal is possible to the Supreme Court of Canada, but only with "leave" of that Court. Either side can file an "Application for leave to appeal". Leave is granted only when the issue is of "national importance". Only a very few tax cases a year are heard by the Supreme Court.

Now, what does all this mean in terms of understanding Court decisions?

- Decisions of higher courts are more precedent-setting. Lower courts are required to follow legal principles set out by the higher courts.

  A decision of the Supreme Court of Canada on a tax issue is extremely important — and rare, as the Supreme Court hears very few tax appeals. Decisions of the Federal Court of Appeal are also very important, especially where they make statements as to principles of law.

  Tax Court decisions under the General Procedure are less important but are still valuable. Even Informal Procedure decisions, which technically are not binding for future cases, are a good indication of where the Court is going on an issue, and in practice the CRA and other judges of the Tax Court will often follow them.

- The Courts will not give much weight to CRA publications such as Interpretation Bulletins. The judge will take note of such documents, but will not consider himself or herself in any way bound to follow the CRA's interpretation — since the CRA is one of the litigants before the Court. The law is found in the Income Tax Act and the case law, not in CRA publications.

- If the government does not like a Court decision, they can effectively overrule it with legislation, by introducing amendments to the Income Tax Act that Parliament then enacts. Many "schemes" that have succeeded in the Courts have been subsequently shot down by amendments to the Act. However, in the interim, taxpayers can still take advantage of the Court decision — unless the legislative changes are made retroactive, which they sometimes are.

AROUND THE COURTS

A NEW WAY AROUND THE DEADLINE FOR FILING A NOTICE OF OBJECTION?

If you disagree with an assessment or reassessment for a taxation year, the *Income Tax Act* requires you to file a Notice of Objection within **90 days** of the date on the Notice of (Re)Assessment for the year or one year after the tax return filing-due date for the year, whichever is later. Without a valid objection, you cannot appeal to the Tax Court of Canada. **The 90 days normally starts running from the day the Notice is mailed**, even if it never reaches you. For taxpayers other than individuals, the objection period is simply the 90-day period after the date of Notice of (Re)Assessment.

If you miss the deadline, the Act allows you to apply for an extension of time for up to **one** year past the deadline. Within that one year, the CRA is fairly generous about allowing applications for extension of time. Past the one year, however, there is no way to have time extended. Your right to object or appeal is gone forever, no matter how good your excuse for missing the deadline. The Tax Court of Canada has confirmed this rule in dozens of cases.

However, there may be a new solution in meritorious cases (such as where you never received the Notice of Assessment, though no fault of your own). In late January 2016, the Federal Court issued its decision in *Conocophillips Canada Resources Corp. v. Canada,* 2016 FC 98 (available on canLii.org). The Court ruled that the CRA is permitted to apply subsection 220(2.1) of the Income Tax Act to extend the time to file an objection. This subsection allows the CRA to "waive the requirement" to "file a prescribed form, receipt or other document".

Conocophillips had asked the CRA to waive the company's obligation to file a notice of objection on time. The CRA refused, saying it had no legal power to do so because subsection 220(2.1) was not intended to apply to a Notice of Objection. Now the Federal Court has ruled that it does, leaving the CRA to make a decision as to whether to waive the requirement as a way of extending the filing deadline.

It is expected that the CRA will appeal this decision to the Federal Court of Appeal, which may well conclude that the Federal Court was wrong. (The Court of Appeal in recent years has repeatedly ruled that taxpayers cannot use the Federal Court to bypass the normal process of appealing to the Tax Court.) Until it does, however, this case offers a glimmer of hope to taxpayers who have missed the objection deadline + 1 year though no fault of their own.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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