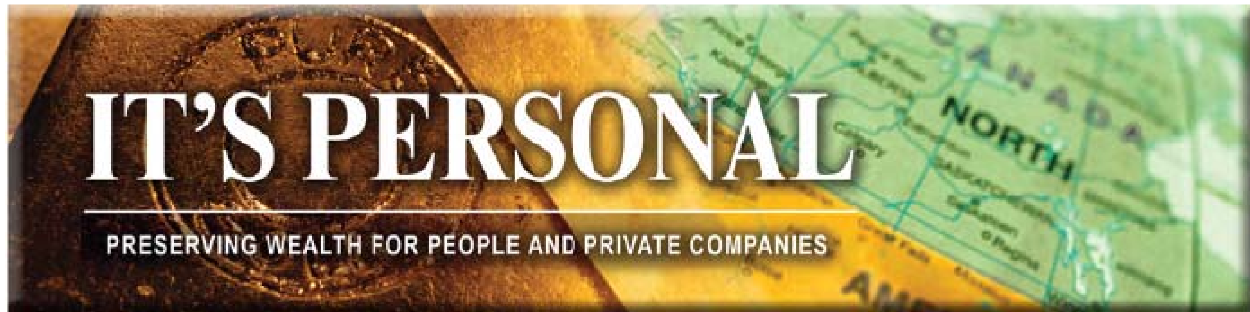

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Of Summer's Past and the Fall of the Tax Evaders –

Extreme caution advisory for Canadian and U.S. taxpayers with unreported offshore accounts

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Now that summer is drawing to an end, it's worth a look back to those months to see what major developments have been taking shape and will affect us in the tax world in the Fall and Winter. Perhaps one of the biggest developments over the summer is the U.S. government's successful attack on Swiss banking secrecy and the deal the American authorities recently struck with UBS. In August, it was reported that UBS would agree to reveal the identities of some 4,450 account holders to the U.S. government. The criteria used to select the 4,450 account holders has been kept confidential. These accounts have an estimated value of some $18 billion USD. The Swiss Justice Minister, Eveline Widner-Schlumpf, has said that the U.S.-Swiss agreement fully complies with the laws of Switzerland and that "with this agreement, we have managed to avoid a conflict between the sovereignty of two states" (WSJ, page C.1, August 20, 2009). In effect, what the U.S. and Switzerland agreed to do was amend the Article on Exchange of Information in their tax treaty, which currently has a public policy clause that would permit Switzerland to deny any requests for information that contravene its laws—for example, its bank secrecy rules. The same article in the Canada-Switzerland tax treaty not only has a similar public policy exception, but unlike the U.S.-Switzerland tax treaty, does not even contemplate situations involving tax fraud, and so is rather toothless. It is interesting to note that both the U.S. and Switzerland disagreed on what constitutes fraud. As reported on September 3rd, the CRA is now making every effort to gain information from UBS to enforce the provisions of the Income Tax Act against Canadians who might be account holders. (G&M, page B.3, September 3, 2009). The headway made by the US and Canadian governments in obtaining taxpayer information is coming as a result of diplomatic and political manoeuvring rather than through any exercise of treaty rights.

The settlement permits UBS to notify its U.S. clients that their account information is going to be given to U.S. authorities. These account holders can file lawsuits in Switzerland in an effort to prevent the information from going to the U.S. government. However, these account holders

would also have to give notice to the U.S. Attorney General if they plan to launch such an appeal in the Swiss courts.

Initially, the U.S. Justice Department issued some 52,000 John Doe summons. In February, 2009, UBS agreed to hand over the names of 250 U.S. account holders that were set up as sham accounts. UBS admitted setting up these accounts and further agreed to pay $780 million (USD) in penalties in order to avoid criminal prosecution.

As most observers have now surmised, the UBS situation is just the tip of the iceberg. While the U.S. has agreed to drop the 52,000 John Doe summons as part of the settlement agreement, the U.S. Internal Revenue Service ("IRS") expects to have the identities of some 10,000 of those 52,000 UBS accounts by January 1st, 2010. As we reported in our May 2009 issue of *It's Personal*, the IRS has initiated a voluntary disclosure program designed to bring U.S. taxpayers back on the right side of the government in relation to their unreported offshore accounts and income. If democracies can be said to tend to act five minutes before midnight, so can delinquent taxpayers—perhaps even 5 minutes after midnight. With news of the UBS scandal and the U.S. voluntary disclosure program headlining newspapers, taxpayers and their advisors are now just starting to wake up and smell the coffee—especially as the closure of the program loom's on September 23rd. The fact of the matter is that the IRS has targeted ten other Swiss banks so American and other foreign account holders should take note.

This unquestionably worthwhile enterprise of identifying Americans who may have used secret accounts to hide money overseas to evade taxes has serious consequences especially for those overseas account holders that merely seek privacy. Moreover, it has tremendous risk implications for legions of Americans living in Canada, who do not file income tax returns or report their Canadian bank/financial accounts to the IRS. The penalty structure of the program unfortunately makes no distinction between outright tax evaders, and other non-reporters who may have reasonable cause.

In Canada, the Canada Revenue Agency (the "CRA") does not want to be left behind in this global governmental move to curb tax evasion. Using its broad array of statutory powers, the CRA is also fast on the hunt for secret accounts.

Most Canadians have truly no great desire to hide from the taxman. They have simply conducted their affairs either with privacy in mind and without advice or on the basis that the maintenance of an overseas account, was and remains, in compliance with the required laws.

The good news is that failure to properly account and report income does not automatically mean that the Canadian tax authorities will lay criminal charges against your client. Depending upon the account holder's circumstances, the CRA could impose civil penalties and/or launch a tax prosecution. Sometimes non-compliance is more about the interpretation of facts and not an outright attempt of misrepresentation or purposeful evasion. Nevertheless, the onus will fall upon the taxpayer's (or the account holder's) "shoulders" to prove innocence.

Interestingly enough, in the summer months of 2009, there has been an unusual uptick in the issuance of Requirements by the CRA. There is no need to frighten clients about the

consequences of the failure to comply with a Requirement. However, it is critical to remind all of your clients that they do have rights and they should be exercised. As you know, if you are a lawyer you can first offer your client the protection of solicitor-client privilege. No such privilege exists for an accountant. And how can you help the client without possessing all of the relevant facts? The Canadian Federal Court of Appeal has ruled that a CRA auditor can require written answers to questions and production of documents by the taxpayer's accountant (*M.N.R. v. Kitsch, Tower & BDO Dunwoody*, 2003 DTC 5540 (FCA)). As we all can agree, protection of your client's rights is key and this requires the proper approach to this potential problem.

A CRA auditor has an amazing amount of statutory powers. For example, subsection 231.1(1) of the *Income Tax Act* (the "ITA") permits authorized persons (i.e. CRA auditors) to inspect, audit or examine the books and records of a taxpayer. This provision authorizes auditors only to inspect documents and not the power to seize or copy them. However, subsection 231.2(1) of the ITA empowers the CRA with the authority to demand information and any document within a reasonable period of time as stipulated in the Notice of Requirement. The sanctions for the failure to comply with an order ultimately issued under section 231.2 are criminal prosecution pursuant to section 238 and contempt proceedings under subsection 231.7(4) of the ITA.

In 1988, the Canadian Parliament added section 231.6 of the ITA which deals with requirements for the production of "foreign-based information". Section 231.6 was originally enacted following the release of the Department of Finance's *White Paper on Tax Reform*, 1987. It recommended changes in the law to make it easier for the Minister of National Revenue (the "Minister") to obtain information about cross-border transfer pricing (see: *White Paper on Tax Reform, Annex 2*, pp. 223 & 224). The fact is that the section is broadly worded and as a result, section 231.6(2), for example, permits the Minister to serve a notice on a resident in Canada requiring the production of documents located outside Canada.

Coupled with the changing international tax environment, these various statutory powers and potential punishments should give you and your clients the uneasy feeling that it is increasingly difficult to avoid the scrutiny of the CRA. Certainly, the recent decision in *eBay Canada* should be even more cause for concern. In *eBay Canada Ltd. v. Minister of National Revenue*, 2008 D.T.C. 6728 (FCA), the Appellant Court upheld the trial judge's findings and eBay Canada Ltd. was forced to release Canadian based customer information it had computer access to, even though the information was stored in California and *eBay Canada Ltd.* did not own this information.

The CRA is also vigorously pursuing an ever increasing number of tax prosecutions for the failure to file a tax return (subsection 238(1) of the ITA) and more significantly, the evasion of tax (paragraph 239(1)(d) of the ITA). The penalties for these types of transgressions are serious and severe. They range from fines to potentially lengthy periods of jail time. The defence of tax prosecutions is costly, especially in terms of the emotional toll, the financial burden and amount of time it consumes.

What we as tax practitioners and our clients are faced with is the harsh reality that there is a worldwide decline in tax havens. Some suggest that it is a consequence of the international financial crisis. Others maintain that it is the natural evolution of an ever shrinking world

especially due to the advancements in technology. Whatever the explanation, it is quite correct to conclude that bank secrecy and privacy is on the wane and tax advisors must act quickly to help their clients.

One avenue that still remains available in Canada is the Voluntary Disclosures Program ("VDP"). The CRA's administrative policy is to not levy criminal or civil penalties on a taxpayer who voluntarily discloses incorrect tax filings (see: CRA *Information Circular* 00-1R2, dated October 2007 as a starting point). The voluntary disclosure cannot only prevent a tax prosecution but financial penalties can be avoided and partial interest relief may be granted.

The CRA has established a set of criteria for a disclosure to be valid under the VDP. It must be voluntary, the information must be complete, it must involve the application of a penalty and it must contain information that is at least one year past due or correct information from a previously filed tax return. There are further limitations to the taxpayer for the availability of the VDP. A disclosure would not be considered voluntary and consequently, not acceptable if the taxpayer was aware of an audit, investigation or some other enforcement action carried out by the CRA. The definition of enforcement action is very wide. In fact, it is so broad it includes such things as requests for tax instalments and even inquiries by other authorities such as the securities commission or police.

While disclosures can be made on a no names basis, the simple fact is that you cannot fully conclude the process without eventually disclosing the taxpayer's identity.

The legislative authority for the program is found in section 220(3.1) of the ITA. It is completely discretionary. Where the Minister denies relief, a taxpayer can request a second level review. This review takes place within the CRA and it is presumed to be performed by an independent CRA officer. If upon a second level review the Minister has still denied the taxpayer relief, a judicial review of the exercise of the Minister's discretion is available to the taxpayer under section 18.1 of the *Federal Courts Act*.

For U.S. taxpayers living in Canada (and abroad) who do not file or report their income and bank accounts they should take note that the U.S. government is working to reconcile its citizenship and green card records with tax return filings. Sooner or later, the IRS will find you. The problems that delinquent taxpayers are creating in their lifetime will not stop there. There are ample U.S. authorities, both in the Internal Revenue Code and Case Law which support the imposition of personal liability for an executor or fiduciary of an estate in regard to taxes, penalties, and interest arising from the decedent's failure to file tax returns and failure to report offshore accounts. Tax advisors, financial planners, and those in the wealth advisory profession should take note that the best advice, without attention to U.S. tax reporting obligations during a client's lifetime can have a ruinous impact on the estate wealth they have worked hard to build and preserve. Moreover, these professionals should also be aware there are special U.S. tax procedures which they can follow to reduce the risk of the executor or fiduciary's personal liability for the 'short sightedness' of their clients in regard to their U.S. tax and reporting obligations. Ignorance is no longer bliss, and neither are the professional fees the estate will have to shell out to clean up the decedent's mess.

If you know of a client that has an overseas account, or has similar delinquency issues to the points we have raised in this news brief, the time to advise and act is now.

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Recent CRA Views

One of the economic stimulus measures included in the 2009 federal budget was the Home Renovation Tax Credit (HRTC). The HRTC is a temporary 15% non-refundable tax credit that applies to home renovation expenditures made between January 27, 2009 and February 1, 2010. The HRTC can be claimed on the part of home renovation expenditures over $1,000 and under $10,000, which results in a maximum tax credit of up to $1,350. Although legislation regarding the HRTC has not yet been released, there have been many CRA Views documents dealing with questions surrounding this new credit. Below are summaries of some of the recent Views documents that have dealt with questions regarding this new credit.

- Views document 2009-0331831E5 dated August 19, 2009 – the cost for sanding and refinishing of hardwood floors, including expenses for labour, materials, and equipment rentals, qualifies for the HRTC because it is a renovation that is enduring in nature and integral to an eligible dwelling. The cost of purchasing any tools would not, however, qualify for the HRTC.

- Views document 2009-0314711E5 dated August 11, 2009 – expenditures for new sod, trees, perennial shrubs and flowers that are planted in land that forms part of an eligible dwelling will qualify for the HRTC.

- Views document 2009-0309181E5 dated August 11, 2009 – expenditures that are incurred in respect of common areas of a condominium and are paid out from a reserve fund or a special assessment cash call will qualify for the HRTC as long as the expenditures incurred by the condominium corporation are eligible expenditures made in respect of eligible dwellings.

- Views document 2009-0311821M4 dated August 6, 2009 – the cost for the installation of a new garage door qualifies for the HRTC because it is of an enduring nature and integral to the dwelling.

- Views document 2009-0314431E5 dated July 28, 2009 – the cost for the permanent installation of security window film qualifies as an eligible expenditure for the HRTC because the installation is integral to the dwelling and of an enduring nature.

- Views document 2009-0328351M4 dated July 21, 2009 – expenditures that are part of the purchase of a taxpayer's new home, including upgrades, will generally not qualify for the HRTC.

- Views document 2009-0327421M4 dated July 21, 2009 – amounts associated with the replacement of an existing driveway qualify as eligible expenditures for the HRTC because, similar to a new driveway or the resurfacing of an existing driveway, the replacement is both enduring in nature and integral to the eligible dwelling (or the land that forms part of the eligible dwelling).

- Views document 2009-0327131M4 dated July 21, 2009 – a homeowner is eligible to claim the HRTC on costs related to work he performs himself, but the value of his labour cannot be included.

- Views document 2009-0325561M4 dated July 21, 2009 – the cost for the removal of a tree does not qualify for the HRTC unless the removal relates to a renovation project that is of an enduring nature and integral to the eligible dwelling because the removal on its own is not integral to the dwelling.

- Views document 2009-0311701M4 dated July 21, 2009 – the costs of renovating a kitchen and installing a new eavestrough qualify for the HRTC; however, costs for appliances are specifically excluded from the HRTC.

- Views document 2009-0322231M4 dated July 17, 2009 – the costs of upgrading, replacing, or newly installing septic tanks would qualify for the HRTC; however, if the cost is part of routine repairs and maintenance, normally performed on an annual or more frequent basis, it would not qualify for the HRTC.

- Views document 2009-0325291M4 dated July 16, 2009 – the costs associated with the purchase and installation of hot tubs/spas which are permanently positioned in place and hard wired into the home's electrical panel would qualify for the HRTC; however, portable hot tubs would not qualify as they are not enduring in nature or integral to the dwelling.

- Views document 2009-0325611M4 dated July 16, 2009 – the costs associated with the purchase and installation of a pool liner would qualify for the HRTC.

- Views document 2009-0319351M4 dated June 29, 2009 – the cost of clearing trees and brush from a cottage lot would not qualify for the HRTC on its own. The clearing must relate to a

renovation project of an enduring nature that is integral to the dwelling to qualify for the HRTC.

- Views document 2009-0321121M4 dated June 23, 2009 – the costs for the installation of solar photovoltaic (PV) panels qualify for the HRTC unless the cost is part of the purchase price of the dwelling.

Cases of Note

Choson Kallah Fund of Toronto v. MNR, 2008 CarswellNat 4147 (F.C.A.), C.M. Ryer J.A., leave to appeal to the S.C.C. dismissed 2009 CarswellNat 935, 2009 CarswellNat 936 -- The Minister of National Revenue issued a notice of intention to revoke the registration of the taxpayer fund as a registered charity pursuant to ss.168(1) of the *Income Tax Act*. The taxpayer fund brought an application, pursuant to para.168(2)(b), for an order extending the period of time that must expire before the Minister was permitted to publish a copy of the notice until the conclusion of the process that the fund had commenced objecting to the notice. The application was dismissed. All of the elements of the three part test set out in case law were not satisfied. The Crown did not dispute that there was a serious issue to be tried; however, the facts asserted by the fund were largely historical and, in and of themselves, did not establish that the fund would suffer irreparable harm if the Crown was permitted to proceed with its revocation as a registered charity. Given that this second element of test was not met, there was no need to consider the balance of convenience. The application for leave to appeal to the Supreme Court of Canada was dismissed with costs on April 23, 2009.

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Hodge, R. v. The Queen, 2009 FCA 210 (F.C.A.), Evans J.A. (Linden, Layden-Stevenson JJ.A. concurring) -- Upon retirement, the taxpayer created a pension plan administered by a numbered company. The plan was registered under s.147.1 of the *Income Tax Act*, but CRA expressed concern regarding the validity of the employee/employer relationship. Locked-in funds from the former plan were transferred to the new plan, purportedly free of tax due to s.147.1. The Minister stated its intent to revoke the plan on the basis that it was not created to provide lifetime retirement benefits, but rather to facilitate a tax-free transfer. The plan’s administrator filed an application requesting that the date of revocation be August 31, 2008, instead of the intended date of June 1, 2001, which was the date of initial registration. The Minister refused and the plan was revoked from its date of registration. The taxpayer brought an application to vary the date of revocation of the pension plan. The application was dismissed. The Minister was acting within its statutory power granted by ss.147.1(12), and properly exercised discretion under ss.147.1(13). When the Minister and administrator have both initiated proceedings to set the date of revocation, the Minister's view will prevail, although the court has ultimate discretion to set a revocation date under ss.147.1(13). The Minister has the responsibility to administer the *Act*, including closing pensions that do not meet statutory criteria. Administration would be hindered if, by applying for revocation as of a certain date, the administrator could prevent the Minister from specifying an earlier date for revocation. There was no reason to vary the date of revocation

from that set by the Minister, and the taxpayer took a calculated risk in ordering his pension affairs as he did.

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Boily v. R., [2008] 4 C.T.C. 2225 (TCC), P. Bédard J.; aff'd 2008 CarswellNat 4711 (F.C.A.); leave to appeal to S.C.C. denied 2009 CarswellNat 1760 (SCC) -- On October 25, 1998, the taxpayer transferred his RRSPs to MRS Trust. On December 1, 1998, the taxpayer sent a letter to MRS Trust, requesting the acquisition of 34,500 class B shares of company RV at $1.00 each and to give a $34,500 cheque to RV. In 2007, MRS Trust gave the taxpayer a share certificate that RV had created on December 1, 1998, attesting that MRS Trust held 34,500 class B shares of RV. The Minister included in the taxpayer's 1999 income the amount of $34,500 as income from the RRSP. The taxpayer appealed the assessment. The appeal was dismissed because, in subscribing for the shares of RV, MRS Trust acquired a "non-qualified investment" under ss.146(1) of the *Income Tax Act* since RV did not carry on business for the taxation year in question. Therefore, the taxpayer should have added $34,500 to his income for the 1999 taxation year according to ss.146(10). The taxpayer appealed to the Federal Court of Appeal. The issue on appeal was whether trial judge erred in concluding that MRS Trust acquired RV shares for the 1999 taxation year. As of December 1, 1998, the taxpayer had express intention to acquire class B shares of company RV. MRS Trust had an obligation to ensure that shares of RV were qualified shares, and asked the taxpayer to provide supporting documentation. MRS trust did not acquire the RV shares in 1998; it determined that the shares of RV were qualified shares at the end of December 1998, and issued a cheque in the amount of $34,500 for the shares on January 25, 1999. Therefore, the appeal was dismissed. The taxpayer's application for leave to appeal to the Supreme Court of Canada was dismissed on June 25, 2009.

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Teffer v. Schaefers, 2008 CarswellOnt 5447, (sub nom. Re Schaefers Estate) 93 O.R. (3d) 447 (Ont. S.C.J.), Fragomeni J. – The respondent Mrs. Schaefers ("S") was diagnosed with Alzheimer's disease in September 2006 and the respondent Mr. Verbeek ("V") was a lawyer whom S named as her attorney in a Power of Attorney for Property and Personal Care ("POA") dated December 4, 1998 and another POA signed April 27, 2006. V did not have S assessed before she signed the April 2006 POA. Despite requests from Mr. Hiltz ("H"), S's counsel under s. 3 of Substitute Decisions Act, 1992, V did not pass accounts. A consent order required V to pass accounts to H, but V did not fully comply. On February 2, 2007, on behalf of S, H brought an application for relief that included an order setting aside V's POA and an order for a passing of accounts. The application was granted. The evidence established that S's best interests were not being met. V's conduct clearly demonstrated an inability to understand and perform his duties diligently, even in the face of two court orders requiring him to do certain things. The characterization of his conduct as tardiness or sloppiness minimized the seriousness of V's non-compliance with court orders or his non-compliance with disclosure requests or his inaction in proceeding with the passing of accounts despite his expressed intentions that he would do so.

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Simonin v. Simonin, 2008 CarswellOnt 6643, [2009] W.D.F.L. 2448 (Ont. S.C.J.), Daley J.– The son and his wife ("Mary") married in 1996 and began living rent free on a property owned by the son's mother ("Matilda"). The son through his construction company commenced substantial renovation work on the property. Mary acknowledged that Matilda had not asked the son to carry out any improvements and that the son never asked Matilda for permission to make improvements and carry out renovations. Mary also acknowledged that she did not know of any agreement by Matilda that, were she to sell property, she would repay the son for costs of improvements made to the property. The son died in 2003. The property was sold for $880,000. Mary brought an action on her own behalf and as estate trustee for the son's estate against Matilda for, among other relief, a declaration that she was entitled to a portion of the net proceeds from the sale of the property as result of unjust enrichment. The action was dismissed. The only possible cause of action available to Mary was an equitable claim of unjust enrichment. While there was evidence that costs of renovations and improvements to the property were paid for by the son's company, there was no evidence of any tax benefit accruing neither to the company nor to Mary and the son. While the manner in which renovation costs were paid for through the company may have been improper, it was not immediately and necessarily related to Mary's claim against Matilda in unjust enrichment. The arrangement did not bar Mary from making a claim for a remedy based on alleged unjust enrichment. Matilda received enrichment in that the property was improved and its value increased as result of renovations carried out. There was no evidence that the Mary personally did anything or contributed money, labour or materials that increased the value of the property. Mary had no personal right of action and it was only in her capacity as estate trustee that she could make a claim. The renovations and improvements were made by company and not by Mary or the son. As such, no benefit was conferred on Matilda by Mary or the son.