September 2017 Edition

The Tax Informant

The Department of Finance Canada and its civil servants in complete disarray (Part 1)

MAJOR MISTAKES AND OMISSIONS, BLUNDERS CAUSED BY "PRACTICAL" INCOMPETENCE, AND LETHARGY ARE CAUSING MAJOR HARM TO TAXPAYERS AND COSTING THE FEDERAL GOVERNMENT A FORTUNE!

By Yves Chartrand, M.Fisc.
Centre québécois de formation en fiscalité – CQFF inc.
ychartrand@cqff.com

In this first of a series of newsletters addressing this significant problem, we will demonstrate, **with numerous concrete examples as proof throughout our series of newsletters**, how this appalling situation developed over the past 15 to 30 years and how it was caused by the inaction of civil servants at the Department of Finance Canada. Industry experts (as well as the Canadian taxpayers they represent) have become the butt of a joke created and perpetuated by these civil servants who seem to live on another planet. In fact, their gaffes are costing billions of dollars. Who pays for all these mistakes? Taxpayers. Except of course, those who have been able to benefit from the incredible ineptitude of these civil servants. The tale of a sad saga **where a real tax chaos is presently building in Canada…**

Context

First, let's be very clear. We are not targeting civil servants working at the Canada Revenue Agency (CRA) because they are only in charge of administrating tax laws. They're not the ones who create said tax laws in Canada. The horror stories we will highlight emanate from the shady Department of Finance Canada and the civil servants operating there. Nor will we blame those who have occupied the role of Minister of Finance over the years, because the horror stories we will share are not the result of a specific political agenda. For instance, we will not criticize or cheer Harper's decision to cut the GST by two percentage points or Trudeau's implementation of the Canada child benefit (CCB). These two examples are part of a political agenda that the civil servants at the Department of Finance had no choice but to implement, whether they were in favour or not. We are not pointing the finger at the politicians, they are not the right target. Instead, we will share numerous examples that were entirely the result of decisions by the civil servants at the Department of Finance. These are instances of civil servants deciding not to intervene at all or taking an egregious amount of time to do so (despite being well aware of the problems for several years, with supporting evidence in hand). We will also show examples of how they intervened in the worst way imaginable.

Our organization is specialized in Canadian and Quebec tax laws and, as a general rule, all our examples will deal with problems related to income taxes in Canada. We will not be discussing issues related to commodity taxes (such as the GST) or international tax laws (such as the impact of foreign subsidiaries) because these topics are not within our scope of expertise. That being said, we don't believe that these sectors have been handled perfectly either. Maybe one day, experts on these issues will be willing to share some of the horrible cases of incompetency they've encountered. We'd be happy to include in-depth examples in our future newsletters, even though we've got plenty of material to fill our next several editions.

Table of contents

Context 1
Six years for a correction to the taxation of "non-eligible" dividends: an oversight that has cost the government at least $2.5 billion 2
"Paved" farmland: several hundreds of millions of dollars exempt from tax for no reason… since 1988!..................................4
Examples of inactions that continue to punish taxpayers, such as the "plex" saga 6
A great example of "practical" incompetence: the partial or total loss of SBD for subcontractors who do not deal at arm's length with a shareholder of another SME 9
Many other examples in future newsletters..... 10

Finally, before diving into concrete examples of just how much of a mess our tax system is, it's important to mention that it is the unending stream of blunders from the civil servants at the Department of Finance, especially over the last 15 years, that have led us to publish this series of devastating articles. The camel's back has finally been broken because of the Department of Finance's incessant gaffes and their constant habit of turning a blind eye to the problems at hand and available solutions… despite several warnings from highly-renowned tax organizations and experts, including this author. Enough is enough! The time has come for them to face the music! It is time to speak up about the incompetency of the Department of Finance's civil servants. After all, these mistakes are costing taxpayers, including middle-class taxpayers, an arm and a leg.

In every edition of our newsletter, we will provide:

i) Concrete examples of oversights and omissions that cost or have cost the federal treasury a fortune

ii) Concrete examples of inaction that harm taxpayers

iii) Concrete examples of "practical" incompetence in implementing tax measures

Notes from the CQFF

1 - We know that in publishing this devastating series of newsletters about the incompetency of the civil servants at the Department of Finance, we will face criticism from every level of the governmental bureaucracy. We are more than ready! Every one of our examples is backed by documentary evidence. And we will respond with other examples that are even more devastating. The time has come to defend the taxpayer from the culture of apathy that poisons the Department of Finance.

2 - To those who believe that we are publishing this series of newsletters as some sort of revenge for the measures announced by the Department of Finance on July 18, 2017 targeting SMEs, its owners and members of their family, we simply want to say, "get real". This author has been researching and documenting the content of these articles for the past two years. The final decision to publish these newsletters was made in the fall of 2016 and the first article was nearly ready for translation on July 18, 2017. **Some** of the measures announced on July 18, 2017 (but not all of them) should have been implemented a very long time ago (such as the restrictions targeting the taxable capital gains allocated by a trust to minor children and stemming from the sale of SME shares). Others, however, can be likened to measures that confiscate the wealth of SMEs and their owners and are a major violation of the concept of integration that is so important in Canadian taxation. We will tackle these topics in one of our future newsletters.

Let's look at a first example of a shortfall… of at least $2.5 billion over six years!

A. Six years for a correction to the taxation of "non-eligible" dividends: an oversight that has cost the government at least $2.5 billion

From 2008 to 2015, the federal tax rate for small companies (SME) was cut from 13.12% (a rate implemented in 1995) to 11.0% (it is 10.5% since 2016). Normally, as per the "principle of integration", an incredibly important and nearly sacred concept in Canadian taxation, a reduction of the tax rate for SMEs should have been accompanied by a higher taxation of dividends derived from the SME's earnings generated by this reduced taxation. As a quick reminder, the concept of integration requires that the dividends received by the individuals and included in their income be grossed-up to roughly correspond to the SME's earnings before taxes and a dividend tax credit (DTC) is granted to the individual on the "grossed-up dividend", essentially corresponding to the tax paid by the SME. Therefore, an individual receives compensation for the taxes paid by the SME via the dividend credit in order to avoid double taxation. As per the principle of integration, the sum of the tax paid by the SME on his profits and by the individual on dividends is supposed to be the same amount as would have been the tax paid by the individual if he had himself earned the income.

What really happened?

It took exactly six years for the Department of Finance's civil servants to make the necessary adjustments. How much did this cost "other" taxpayers? At least $2.5 billion. Was it difficult to calculate this amount? Not really… We simply took the Department of Finance's own figures from the federal budget of March 21, 2013

in which they listed the annual additional revenue they would be collecting for every fiscal year from 2014-2015 to 2017-2018 (with an annual growth in revenue of slightly more than 6%) and we applied the same principles by retroactively calculating it from 2008-2009 to 2013-2014 (with the necessary little adjustments). And this figure is conservative because the Department of Finance has stated, in a document obtained under the Access to Information Act, that the federal tax system was "over-integrated" for non-eligible dividends by an average of 1.4%. For residents of Ontario, this federal figure came out to 1.65% in 2008 and 2009, 1.55% in 2010, and 1.46% from 2011 to 2013.

Are we sure that the civil servants working at the Department of Finance made a mistake by not adjusting the taxation of dividends?

Absolutely… they even say so themselves in their budgetary documents (Budget plan 2013, page 336, paragraphs 3 and 4):

"The current DTC and gross-up factor applicable to non-eligible dividends overcompensate individuals for income taxes presumed to have been paid at the corporate level on active business income. As such, an individual who receives dividend income from a corporation is in a better tax position than if the individual had earned the income directly.

To ensure the appropriate tax treatment of dividend income, Budget 2013 proposes to adjust the gross-up factor applicable to non-eligible dividends from 25 per cent to 18 per cent and the corresponding DTC from 2/3 of the gross-up amount to 13/18. Expressed as a percentage of the grossed-up amount of a non-eligible dividend, the effective rate of the DTC in respect of such a dividend will be 11 per cent."

By way of comparison, in 2007 (when the federal tax rate for SMEs was 13.12%), compensation allocated to individuals for the federal tax paid by the corporation was 13.33% (very similar to the federal corporate tax rate of 13.12%) whereas the compensation allocated to individuals from 2008 to 2013 via the dividend credit for federal taxes paid by the corporation remained at 13.33%, despite a reduced corporate federal tax rate of 11% since 2008.

Additionally, this "tax gift" erroneously granted between 2008 and 2013 to Canadian taxpayers having earned non-eligible dividend income allowed our organization to identify in 2013 another problem, this time related to dividends allocated to Quebec residents (more than 650,000 Quebecers are affected every year), due to the 16.5% federal tax abatement that applies to the dividend tax credit (non-eligible and eligible) for federal taxes. That allows the government of Quebec (thanks to rules on transfer payments) to fill its pockets on the back of 650,000 Quebecers (see the note at the bottom of the page to read this study in French[1]).

Here is what we wrote in September 2013 on page 5 of our document published after the civil servants at the Department of Finance made the adjustments to the taxation of non-eligible dividends:

"After analyzing these scenarios and noticing the differences at the federal level regarding the dividend tax credit and taxes paid by the company, there are a few issues that we cannot overlook… Killer questions…

How is it that no one working for the tax authorities noticed this gift of a few billion dollars for non-eligible dividends, a situation that has existed since 2008?"

As further evidence, one needs only to take a look at the documents included in the April 21, 2015 federal budget which announced new progressive tax cuts for SMEs in 2016 (from 11% to 9% over four years, but in the end, only the first 0.5% cut was implemented). The budget planned for **immediate changes** to the taxation of non-eligible dividends. Civil servants at the Department of Finance thereby admitted they had

[1] Please visit **www.cqff.com/liens/integration.pdf**

been dragging their feet from 2008 to 2013. In addition, as a result of an access to information request that we recently made, the Department of Finance admitted that the dividend tax system at the federal level had been "over-integrated" for non-eligible dividends during that period. This is a very technical expression to basically say that they had been asleep at the wheel and that non-eligible dividends were not taxed enough! In the documents obtained from our access to information request, they provided a very evasive and non-committal answer as to why this was not done in 2008 instead of announcing it in the 2013 federal budget (but would only apply in 2014). We therefore took it upon ourselves to list the consequences of their negligence: this gaff cost the federal government at least $2.5 billion by allocating this amount to taxpayers who should not have received this advantage (including this author) … and it is not the only mistake that has been committed. Other devastating examples will be given in future publications, we promise.

B. "Paved" farmland: several hundreds of millions of dollars exempt from tax for no reason… since 1988!

Did you know that if an individual sells farmland they've inherited (or received in any other way) from their mother 10 years ago and they sell it now at a very high price to a real estate developer, they can still claim a $1,000,000 capital gains tax exemption, even if the last person to grow anything on the land was the individual's direct ascendant (father, grandfather, great grandfather) in the 1950s? Even if the land has been zoned "commercial" for the past 25 years? Did you know that this author has acted as a tax advisor in several situations of this kind and that transactions worth tens of millions of dollars were tax exempted? Did you know that those who take part in our seminars (more than 9,000 last year) have also exempted significant amounts for clients over their professional career? Did you know that tax authorities have published myriad technical interpretations since 1990 submitted by professionals who confirm these outlandish benefits exist for an individual who has simply had the luck of being born in a family that owns what had previously been farmland?

Let's start from the beginning… Such a surprising (and unacceptable) situation stems from the White Paper on Tax Reform published on June 18, 1987 by then Minister of Finance Michael H. Wilson. As part of the reform, the civil servants at the Department of Finance wanted to restrict access to the $500,000 capital gains tax exemption (the limit applicable at the time, it has now increased to $1 million for farm and fishing property). They introduced a "gross revenue test" and a "24-month holding period test".

These changes were announced in 1987 under the pretext of preventing part-time farmers from claiming this exemption. **However**, as part of legislative measures adopted within Bill C-139 at the time, the federal government also added a new clause to this law. They added the "father or mother" to the list of people having owned the farm property or operated the farm business in the individual's family history, for the purposes of eligibility to the tax exemption. By doing so, the federal government paved the way for a $1 million ($500,000 at the time) tax exemption on farmland. A jaw-droppingly generous gift! In fact, for the specific purposes of this legislation, the words "father and mother" also include grandparents and great-grandparents (first generation).

This means that if an individual inherited land from their father in 1998 and that this land generated gross revenue higher than the net income from other sources in 1959 and 1960 for the father (the 2-year gross revenue test), it is considered farmland for tax purposes, even if today that same land is zoned "commercial" and has not been used for agriculture in 60 years! Zoning has no impact on the definition of "qualified farm property" and the added value of the land may have occurred in the last decade even if nothing has grown on the land for 60 years.

Think we're making this up? Unfortunately, we are not. As mentioned above, dozens of technical interpretations published by the CRA since the 1990s confirm this.

A first case in 1988: five siblings enjoy a $2.3 million tax-exempt gain for a land unused for farming since 1963!

We first encountered an example of this scenario very shortly after the tax reform of June 1987. A CPA (CA at the time) came to us because his clients (five siblings) had inherited land when their mother passed away in 1981 and they had been approached by a real estate developer in the west end of Montreal with an offer of $2.3 million for the land. They wanted to know how much they'd have to pay in taxes because the land itself had a low tax cost (ACB). In fact, as mentioned above, they inherited the land after the death of their mother in 1981 and those a bit older will remember that 1981 was a time of recession and "20% interest rate"! The market value of the land was low in the early 80s but 1988 marked the upcoming end of a real estate boom that began around 1983.

When we spoke to the siblings, we learned that until 1963, the land had only been used for farming purposes by their father. After that, the land remained untouched. Their father passed away and left it to his wife (the mother of the five siblings). By analyzing the new legislative provisions in force since 1988 when the civil servants at the Department of Finance added the possibility of taking into account the family history dating back to great-grandparents, we were shocked to realize that **each** of the siblings, joint owners of the land, qualified for a $500,000 (at the time) exemption for a total of $2.5 million (which would be $5 million in 2017!). The capital gain amounted to $2.3 million, and this was the amount exempted from tax. Honestly, we were so surprised that a $2.3 million capital gain which had accumulated from 1983 to 1988 could be exempt from taxes because it was a "qualified farm property" even though the land had been unused for farming since 1963. In fact, this was so outrageous that we wondered if we were wrong. We consulted a very renowned tax expert, and after going over the new legal provisions of 1988 with a fine-tooth comb, she reached the same conclusion. These were tax-exempt gains which should not have been exempt. In fact, there should be a capital gain exemption on qualified farm property, but only up to the maximum of the land's fair market value (FMV) on the day it stopped being used for farming purposes by a member of the family (direct ascendants or descendants). Any increase in value after the land is no longer used for farming should be considered the same as any other investment (real estate or stock). Is this so difficult to understand? Of course not. But for nearly 30 years now, it has been a free-for-all when it comes to exempting sellers of "paved" farmland whose gains should have been taxed, due in part to the real estate development caused by urban sprawl. For the past 25 years, we've been bringing up this unfair advantage in our seminars.

Because an individual can retroactively request a tax adjustment 10 years later due to ignorance of the rules (such as on the capital gains tax exemption on "paved" farmland), and **until 2004**, it was possible to retroactively request adjustments for issues dating back to 1985, we don't need to tell you that we discussed this "loophole" with thousands of our participants (CPAs, tax experts, accountants, financial planners, etc.) to modify tax returns as old as 1988 of their clients to claim this exemption, if applicable.

To those who still believe that this situation has not occurred frequently since 1988, we're here to tell you that you are wrong. We are not talking about tens of thousands of dollars uselessly exempt over 30 years, but at least several hundreds of millions of dollars over 30 years (which would be a meager $30 million in tax-exempt capital gains per year throughout Canada for a total of $900 million, and it's perfectly within the realm of possibility that this sum is much higher due to urban sprawl). Trust us when we say that we are talking about incredibly large sums of money. This author has acted as a tax adviser in several transactions where tens of millions of dollars were exempt from tax for no reason other than a fortunate family history.

How is it then that the civil servants at the Department of Finance remained unaware of this situation for the past 30 years, despite the numerous technical interpretations published by the CRA to this effect (see technical interpretation 2005-0144881E5, among many others)? Do they not read these publications? The answer is that this is simply one of the many cases of **practical incompetence** and not simply a mistake. Despite repeated warnings, such numerous technical interpretations from the CRA, articles on tax issues

(including one penned by this author in November 2002), a recommendation from the Québec Taxation Review Comittee in a March 2015 report, and more, nothing has been done. And yet, the rule only needs a simple modification: to limit the tax-exempt gain to the FMV of the land at the moment it ceases being used in farming by an eligible individual.

Some might ask why we are revealing this "secret" (which isn't really one) to the tax authorities since it might prevent other people from benefiting from this tax exemption. Because it is other taxpayers (including those in the middle-class) who are bearing the burden for this bureaucratic indifference. Our jaws almost dropped when we read page 211 of the March 22, 2016 budgetary plan:

> *"In addition, the Government remains committed to ensuring federal tax expenditures are fair for Canadians, efficient and fiscally responsible."*

And this is only the first of a series of examples. You'll see… your blood will boil!

C. Examples of inactions that continue to punish taxpayers, such as the "plex" saga

As mentioned at the beginning of this bulletin, the tax community is generally ignored by the civil servants at the Department of Finance. Actually, only groups representing disabled individuals have had a certain amount of success in the last decade (particularly with the implementation of the Registered Disability Savings Plan). You can thank Jim Flaherty who was both the Minister of Finance and the father of a child with a severe impairment caused by brain damage[2]. Mr. Flaherty understood the challenges facing disabled people and it's a good thing he was able to provide so much help to disabled Canadians through his direct interventions at the Department of Finance.

That being said, the tax community cannot brag about having that much sway with these civil servants, even if the problem is sometimes so obvious that it requires immediate attention and a change to the tax system to ensure fairness and eliminate the disparities that affect certain groups of taxpayers. We will provide **many examples** in upcoming newsletters, and in some cases, you'll see that despite significant efforts from experts, the civil servants at the Department of Finance continue to turn a blind eye to the problem, resulting in outlandish situations. The situation has become so bad that it is worth wondering if they are interested in overseeing a fair and balanced tax system or if they'd rather continue to sit in their offices twiddling their thumbs…

This author remembers an event that took place in the summer of 2012, following a major gaffe by the Canada Revenue Agency (CRA) in applying a new rule in relation to the Canada Child Tax Benefit (CCTB) which was replaced in 2016 by the Canada child benefit (CCB). At the time, the Department of Finance announced a measure that would impact single parents who partnered up with a new tax spouse (a completely appropriate measure in terms of tax policy). **However**, the CRA made a mistake by moving the date forward in their computer systems. This mistake cost 57,341 families (figures obtained later as per the Access to Information Act) between $65 million and $75 million.

Our organization noticed this colossal error as early as spring 2012 and fought hard to correct this mistake, even though the CRA's civil servants continued to deny the existence of the problem until we finally made them admit to it by going to the media[3]. But this author remembers very well that he talked with the civil servant overseeing this new tax measure for the CCTB at the Department of Finance. The goal was to make

---

[2] See the following link for more details: http://paralympique.ca/nouvelles-et-evenements/communiques-de-presse/jim-flaherty-il-a-fait-une-difference-pour-les

[3] Visit the following website for the complete saga: www.cqff.com/avis_important/actualite_19sept2012.htm

him aware of the immense problem we identified on the CRA's side. We hoped he would act accordingly to fix the problem and help the tens of thousands of families affected. Unfortunately, things did not go as planned. He seemed uninterested in the matter and could not have cared less. Despite the Canadian tax system costing 57,000 families an extra $75 million! It is only when the media started reporting on this issue and the House of Commons took an interest that the problem came to light. The Minister of National Revenue at the time (Gail Shea) had to apologize to the numerous families hurt by this mistake. The problem could have been solved much quicker if the Department of Finance had stepped in to correct this horrendous error.

Now, let's give you a very real example of a tax problem that still exists. One that can affect **middle-class** taxpayers who own a "plex" building (duplex, triplex, quadruplex, etc.). Despite our efforts over the past 5 years to bring this problem to the attention of the civil servants at the Department of Finance and fix it and despite the numerous inconsistencies involved, many middle-class "plex" owners are being shortchanged because of the laziness and carelessness so rampant at the Department of Finance.

The "plex" problem and the change in use rules

As you probably already know, when property ceases to generate business or property income or when it starts to generate this kind of income when it had up to that point been used for personal purposes, this situation results in a deemed disposition at fair market value (FMV) that can result in a capital gain for the owner. However, it is possible to avoid this by electing under paragraph 45(2) or (3) of the ITA. Depending on the situation, this could be extremely useful. For instance, an owner of a duplex decides to retake possession of one of the units she has been renting out and make it her principal residence. By electing under paragraph 45(3) of the ITA, the owner would avoid having to immediately pay several tens of thousands of dollars in income tax on the capital gain stemming from the deemed disposition at FMV even though the building was not actually sold. In this current climate where property is being sold for record prices, electing under paragraph 45(3) of the ITA seems to be a valid choice. **But wait… it's not what it seems!**

Within the context of a change in its administrative position, one that had been well understood by the tax community for a while, the Canada Revenue Agency stated in its 2011-0417471E5 and 2011-0420171E5 technical interpretations that it now considered a duplex (triplex, quadruplex, etc.) to be one **single property** and if one of the units was subject to a change in use, it would be a **partial** change in use. It therefore became impossible to invoke paragraphs 45(2) and (3) of the ITA in order to delay the tax consequences because it is only a partial change in use. This is a catastrophe for "plex" owners, more specifically in cases where they've converted rental property to their principal residence, because there is no way to avoid the tax bill on capital gains stemming from the deemed disposition that applies to the unit that has changed in use. Who are mostly "plex" owners? **Middle-class and upper middle-class taxpayers**, not the "super wealthy".

Before the change in its administrative position in 2012, which was very surprising indeed, the Canada Revenue Agency had repeated in 1994 as part of the elimination of the $100,000 capital gains tax exemption as well as in their 2000-0047535 technical interpretation published in November 2000 that each unit of a "plex" was considered a separate property. Moreover, in their 2000 publication, the CRA specified that each of the four units in a quadruplex was considered a **separate property** for the purposes of the rules on change in use. The CRA also stated that this was consistent with their previous position (technical interpretation EC1987) and if the building was considered a single property in this situation, applying paragraphs 13(7) d) and 45(1) c) of the ITA would result in a situation that did not represent reality!

Following the change of the CRA's long-term administrative position on "plexes" and in light of the practical problems this would cause many taxpayers, our organization submitted in June 2013 a list of detailed questions to the CRA ahead of a roundtable discussion with tax authorities scheduled for the Association de planification fiscale et financière (APFF) Annual Conference scheduled for the fall of 2013. One question was indirectly aimed at the civil servants of the Department of Finance, even though none of them showed up for

the roundtable discussion. We asked the CRA if it was possible to notify the Minister of Finance of this problem, and **we recommended a very simple solution**. We simply asked that the Minister of Finance modify the tax legislation to use the term “unit” when there was a change in use of the building, which would then harmonize the tax law with other well-known provisions on personal residences.

The rules on the tax exemption for principal residence, the Home Buyers’ Plan (HBP) and the first-time home buyers’ tax credit all use the concept of “unit”, not “property”. Therefore, each unit in a “plex” is treated separately for these three tax measures outlined in the tax legislation. Why should this then be different when it comes to elect under paragraphs 45(2) and (3) of the ITA for a plex? In fact, the CRA’s long-term administrative position (prior to its decision to change it in 2012) was in line with policy created by the civil servants at the Department of Finance and had never been criticized by the latter. It is very hard to explain why these legislative guidelines are not in sync when it comes to the tax policy on personal residence. If an individual owns a few separate units in a condominium building, he will be able to invoke either paragraph 45(2) or (3) of the ITA without any problem, because these properties (units) are separate.

After submitting our questions in June 2013 ahead of the roundtable discussion in October 2013, the CRA responded once again that their (new) administrative stance regarding the impossibility of electing under paragraphs 45(2) or (3) of the ITA on the plex issue was indeed brought to the attention of the Department of Finance.

Three years later, in June 2016, our organization decided to once again sound the alarm on this issue since the civil servants at the Department of Finance had done absolutely nothing to fix this serious problem. Furthermore, since more than 9,000 practitioners (most of them CPAs, accountants, tax experts, and financial advisors) take part in our seminars every year, we are frequently hearing about problematic practical cases. “What should we tell our clients who have to deal with a potentially huge tax bill after making what they thought was an easy decision – moving into one of the units they had previously rented out in their plex?”

Once again, we submitted very detailed questions to both the CRA and the Department of Finance ahead of a roundtable discussion scheduled to take place at the APFF Annual Conference in October 2016. The questions submitted to the CRA, accompanied by a list of problems encountered, detailed explanations, and contradictory positions were clearly outlined and the CRA provided us with a list of answers on what to do in these situations. Obviously, we also questioned the Minister of Finance about the tax policy related to this problem.

Surprise, surprise… the civil servants at the Department of Finance gave us a meaningless, non-committal answer. They simply repeated, *“We will take into consideration the concerns and issues raised in this question during our continual review process of the Income Tax Act rules.”* This typical answer from these civil servants is nothing new to us. The problem is that they refuse to pursue any kind of action. We will be able to give you many specific examples in future newsletters. And yet, how much would it cost the government to modify their tax legislation to adapt the concept of “housing unit” used by several other tax rules surrounding a principal residence (instead of a concept of “property”)? Absolutely nothing because we’d simply be going back to the same situation that had existed before the change in the CRA’s administrative position in February 2012.

Would the tax system be more balanced and fair overall, **especially for the middle class**? The answer is yes, of course it would. Would it be more complicated? Not at all, despite what our brilliant but lethargic civil servants at the Department of Finance would have you believe. One simple subsection added to the law would be sufficient to create a presumption in the case of a “housing unit”. The legislative change should be declaratory (as if it had always been in place). Why have they done nothing in the past five years despite our repeated warnings that this is a major problem? Simply put, they don’t care about the problems taxpayers face. This will be made even more evident in future newsletters.

D. A great example of "practical" incompetence: the partial or total loss of SBD for subcontractors who do not deal at arm's length with a shareholder of another SME

The example in section A of the six-year delay in modifying the taxation of dividends showed a $2.5 billion mistake simply because a "theoretical" concept that is well-known and important in taxation (the concept of integration) was ignored. In fact, some civil servants at the Department of Finance (when they do finally decide to act) show that they are completely unaware of what real life is for a taxpayer. We will provide other examples in our upcoming newsletters, and trust us, we've got plenty! The situation can be summed up as "How to penalize 99.5% of taxpayers who are acting legally in order to try to catch the 0.5% who are not."

The potential loss of eligibility for the reduced rate of taxation of SMEs for subcontractors who do not deal at arm's length with a shareholder of an SME: in our opinion, a mess of a piece of legislation…

In its federal budget of March 22, 2016, the Department of Finance announced a series of tax measures that sought to end the easy access to the small business deduction (SBD, the reduced tax rate of SMEs on the first $500,000 in annual profit). Let's quickly go over this. Even if some doctors, lawyers, and accountants who are part of professional groups that have taken advantage of this situation since the mid 2000s do not agree with this new limit, we are completely in favour of this new legislation. In our opinion, it was completely unwarranted for a group or pool of 10 doctors or lawyers working together to take advantage of the reduced tax rate on the first $500,000 in annual profit (potentially 10 times $500,000, so $5 million in this example) instead of one single limit of $500,000. In fact, this strategy, which had become possible in the mid 2000s after a few rulings by the CRA, should never have been possible in the first place. We have no problem with the Department of Finance restricting this possibility for pools of professionals. **This restriction should have been implemented much earlier.**

Many professionals have used this strategy to multiply their SBD by relying on a technique that involved, among other things, a partnership in order to avoid any problem with the concept of "personal services business". However, the Department of Finance Canada slammed the door on this possibility and implemented new rules so that this strategy of multiplying SBDs by professionals could not be done by a "central professional corporation" either.

Even though we don't have a specific problem with this objective, the way the civil servants at the Department of Finance prevented the use of a "central professional corporation" to multiply the SBD **is so bad that we almost think it's a scam**. Indeed, the method they decided to implement demonstrates that the technocrats and bureaucrats in charge are completely clueless as to how an SME actually operates in the real world. It is amateurish, sloppy, and an affront to anyone in the business world.

In this context, the problem of SBD multiplication problem could have easily been prevented by a specific anti-avoidance rule that could have deterred anyone tempted (see paragraphs 83(2.1) and 129(1.2) of the ITA for examples of specific anti-avoidance rules that work very well). Furthermore, the civil servants at the Department of Finance implemented a specific anti-avoidance rule in paragraph 125.9 of the ITA and it would have been simple to add another one specifically targeting central professional corporations. **But no!** These civil servants chose another route… **one that is much more harmful to Canadian SMEs and has nothing to do with the problem** targeting professional groups (such as doctors, lawyers, and accountants). Crazy, right? You have no idea!

Here are a few examples (based on real life) of SMEs who will lose part or the entirety of their SBD right on their profits due to a nefarious legislation that was implemented by these civil servants:

i) A local construction SME has obtained a major contract for renovating a building that houses a Caisse Desjardins. Caisses Desjardins are structured as cooperatives and are presumed, for section 125, to be private corporations in accordance with subsection 136(1) of the ITA. The entrepreneur's spouse is a member of this Caisse Desjardins and has several accounts there. As a member of a cooperative, she is

considered to have a direct or indirect interest in a private company, which is in reality a cooperative. The entrepreneur in the construction industry therefore does not deal at arm's length with an individual (his spouse) who has an interest in this Caisse Desjardins and because the income earned from this renovation contract will represent more than 10% of the company's yearly income, this income will not be subject to the SBD. What fool thought this would be a good idea?

ii) SME Inc. specializes in installing residential doors and windows. Peter is the sole owner. His installation contracts come, more or less equally, from three separate manufacturers of doors and windows in the region. As a subcontractor for separate manufacturers, the installation company who employs eight people is constantly busy and avoids being economically dependent on any single door and window manufacturer. Peter's brother-in-law, who is a shareholder of ABC Inc. that manufactures windows and doors, helped him when he launched his company by giving him his first contracts ten years ago. Following the new rules implemented in 2016, SME Inc. will lose its right to the SDB on about a third of its income because his brother-in-law is a shareholder of one of the three manufacturers that hire Peter's company to install their products. This is a perfect example of the exact situation in which countless companies in the residential or commercial construction industry find themselves (for instance, a company who installs gypsum for a general contractor) as well as many other fields (pool installation, the IT sector, the agri-food industry, etc.). What fool thought this would be a good idea?

iii) Several Canadian jurisdictions allow real estate brokers to incorporate their company. However, in accordance with some provincial laws regulating real estate brokerage (such as the *Real Estate Brokerage Act* in Quebec), the real estate broker must be affiliated with a "real estate agency". In accordance with these rules, the commission generated from the sale of a building must first be paid by the customer to the real estate agency who then gets billed by the incorporated estate broker. Now imagine the following situation that can happen. Nadia is a real estate broker part of the RE/MAX network and her business is incorporated. She is affiliated with the real estate agency of her region which also includes 75 other real estate brokers. Nadia's sister is a shareholder of this agency. Nadia's company will not have the right to claim the SDB in this example, because 100% of her company's commission from SMEs must first be paid, in line with the *Real Estate Brokerage Act*, to the real estate agency in which her sister is a shareholder. What fool thought this would be a good idea?

Many specialized tax organizations have already provided plenty of examples of this absurd rule that overreaches by creating too many innocent victims who operate SMEs. And yet, the civil servants at the Department of Finance look absolutely ridiculous as they turn a blind eye to this situation… They act as if there is no problem at all. Gross incompetence? You bet.

E. Many other examples in future newsletters

Obviously, there are many other equally devastating examples of inertia and incompetence of the civil servants at the Department of Finance. And in most examples, you'll see that they are well aware of the problem… and have been for a very long time. You'll be astounded by their lack of competency.

The civil servants at the Department of Finance are guilty of wasting public funds, total inertia, a complete lack of understanding of "the real world", and a continued refusal to listen to tax experts… All to the detriment of the taxpayers! To be continued… in our future newsletters!

Yves Chartrand, M.Fisc.

Centre québécois de formation en fiscalité – CQFF inc.
CQFF.com