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The Tax Informant

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

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

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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[1]. 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[2]. 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 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

[1] 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

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

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.