TAX ALERT

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U.S. Tax Review: Dark Clouds of Uncertainty on the HORIZON FOR 2012

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In this *Tax Alert,* we review the general state of U.S. tax affairs in Washington as 2011 drew to a close, and highlight the transition of the voluntary tax filing initiatives for non-compliant U.S. tax filers from the 2011 Offshore Voluntary Disclosure Initiative (OVDI) program to the 2012 Voluntary Disclosure Program (VDP).

The 2011 calendar year came to a tumultuous and infamous conclusion in terms of U.S. tax developments. Although the Internal Revenue Service (IRS) enjoyed some success as the second tax amnesty program ended, the level of fear created by the 2011 OVDI program, through a lack of clear guidance and a crippling penalty regime, was unprecedented and arguably misdirected. Nonetheless, the IRS collected $4.4 billion in taxes under the 2009 and 2011 amnesty programs, with a total of 33,000 voluntary disclosures.

"The 2011 calendar year came to a tumultuous and infamous conclusion in terms of U.S. tax developments."

The media attention garnered by the offshore tax initiatives cannibalized efforts by Congress to restore confidence in the U.S. tax system by eliminating uncertainty created by tax patches, tax extenders and expiring provisions.

In spite of the efforts to increase compliance, on January 6, 2012 the IRS released its first update in five years to its estimates of the tax gap. It found that the effort to reduce the amount of unpaid taxes owed by U.S. taxpayers has essentially failed. The net tax gap for 2006 was estimated to be $385 billion, representing tax that will never be collected by the IRS. The 2001 estimate was $290 billion. In contrast, the voluntary compliance rate for 2006 was 83.7%, the same rate as in 2001. All this comes at a time when the IRS is offering buyouts to 5,400 IRS employees as it begins preparing for a likely budget cut of more than 3%.

The following general comments review the 2012 VDP for those U.S. persons who are still not fully compliant with their U.S. tax filings. A summary of the announcement released in December 2011 for the category of "dual citizens" is also reviewed and should provide welcome relief for U.S. persons living in Canada.

VOLUNTARY COMPLIANCE PROGRAMS

The new 2012 VDP

The IRS reopened a volunteer disclosure program (VDP) on January 9. This 2012 VDP shares many characteristics with the 2011 program, which officially expired last September. One key difference is that, under the new program, taxpayers in the highest penalty category might see a hike in the amount they will have to pay.

Those who come forward and declare previously undisclosed foreign bank accounts will have to pay a penalty of 27.5% of the highest aggregate balance in those accounts or entities, or the value of the foreign assets during the eight full tax years prior to the disclosure. That is an increase from 25% in the 2011 program.

Some taxpayers will be subject to 5% or 12.5% penalties, which are basically the same as in 2011. Unlike the 2009 and 2011 amnesty programs, however, this one is intended to last for an indefinite time, so the IRS should not need to keep re-extending it and trying to come up with ever harsher penalties.

Though the penalties are somewhat higher under the new program, the IRS was practically forced to increase the penalties because the program is designed to encourage taxpayers to come forward as soon as possible.

However, unlike the 2009 program, the 2011 and 2012 programs do not allow taxpayers to argue reasonable cause to get the penalties reduced. Those who wish to make that argument must submit to an IRS audit. In some cases, taxpayers requested intervention from the IRS's Taxpayer Advocate Service when they felt the penalty was unwarranted. Those who opted out of the 2011 Offshore Voluntary Disclosure Program could also go to the IRS's Appeals Office.

The 2011 Offshore Voluntary Disclosure Initiative took away some of the IRS's discretion under the 2009 program and forced taxpayers to undergo audits if they

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wanted the IRS to consider any mitigating factors. The new 2012 program is expected to be similar to the 2011 program, but the IRS has yet to issue Frequently Asked Questions (FAQs) and additional guidance, so there may be some relief. In 2011, the IRS continued the recent trend of issuing "guidance" outside the traditional Revenue Rulings, Notices and other official documents.

Details about the 2011 Offshore Voluntary Disclosure Initiative, for example, were provided almost exclusively in FAQs posted on the IRS website. IRS officials have explained that FAQs and other online materials enable the agency to provide information quickly to taxpayers. Additional guidance is expected by the end of January.

The dual citizen VDP

In December 2011, the IRS issued a fact sheet (FS-2011-13) outlining information for U.S. citizens or dual citizens residing outside the U.S. In it, the IRS clarified the basis for avoiding the penalties under the Foreign Bank Account Reporting (FBAR) Rules, stating that penalties would not be imposed in all cases on non-compliant persons.

Taxpayers who owe no U.S. tax (e.g., due to the application of the foreign earned income exclusion or foreign tax credits) will not be subject to penalties for failure to file or failure to pay. In addition, no FBAR penalties apply to violations that the IRS determines were due to reasonable cause, based on a consideration of the facts and circumstances.

Reasonable cause relief generally is granted when taxpayers can demonstrate that they exercised ordinary business care and prudence in meeting their tax obligations but nevertheless failed to meet them. In determining whether a taxpayer exercised ordinary business care and prudence, the IRS will consider all available information, including:

- Reasons given for not meeting the obligations
- Taxpayer's compliance history
- Length of time between the failure to meet the tax obligations and the subsequent compliance
- Circumstances beyond the taxpayer's control.

Reasonable cause may be established if the taxpayer shows that he or she was unaware of the specific obligations to file returns or pay taxes. Among the facts and circumstances that will be considered are:

- The taxpayer's education
- Whether the taxpayer has previously been subject to the tax
- Whether the taxpayer has been penalized before
- Whether there were recent changes in the tax forms or law that the taxpayer could not reasonably be expected to know
- The level of complexity of a tax or compliance issue

It is not clear if the IRS plans to administer taxpayers' submissions under the 2012 VDP in a similar manner as the dual citizen submissions where no U.S. tax is owed. Given the IRS position on what constitutes reasonable cause under the 2012 program, guidance is required and expected shortly.

FOREIGN BANK ACCOUNT REPORTING

Reporting generally is required by June 30 of each year. During 2011, however, the Treasury Department and the IRS postponed certain FBAR-related deadlines. They announced a one-year extension, to June 30, 2012, for filing the FBAR by certain financial professionals with only signature authority over foreign financial accounts.

Tune in to the Spring issue of *Tax Alert* for more discussions about the notable developments in U.S. tax affairs in 2012. Contact your Collins Barrow adviser for more information. §

GST/HST Audits and Pre-Assessment Reviews:
ARE YOU READY?

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The harmonization of the GST in Ontario and British Columbia brought about significant changes in the way the Canada Revenue Agency (CRA) administers the GST/HST. In its efforts to reduce the compliance burden of audit activities on businesses, the CRA discontinued the use of combined audits for businesses with annual sales of less than $4 million (which covered both income tax and GST/HST), and moved toward having dedicated GST/HST auditors. Moving forward, businesses will be subject either to an income tax audit or a GST/HST audit.

Pre-assessment reviews

The biggest change is the expanded and increased use of pre-assessment reviews. Pre-assessment reviews occur when GST/HST returns are subject to an impartial electronic review to identify potential errors or indications of non-compliance prior to assessment.

Businesses receive a letter from the CRA asking them to explain what their revenue sources are, to provide a listing of the input tax credits claimed, and to provide copies of invoices for the five largest input tax credits. Such requests usually require a response within 14 business days. Often, the returns identified through this pre-assessment review process are referred for further review, and in some cases audits, prior to assessments.

Once the pre-assessment process is complete, a notice of assessment is issued to the registrant either confirming the return is assessed as filed or identifying the adjustments made to the taxes paid/refunded. In Ontario, the recapture of input tax credits has been an area of particular concern. Businesses with significant refunds that are out of the ordinary are likely to be reviewed.

Audits

What causes a GST/HST audit? Most audits result from an assessment of risk of non-compliance. The CRA has a complex computer system that allows it to select returns to be audited by sorting them into various groups. There are four common ways the CRA selects files for audit:

1. Computer-generated lists – The CRA often compares selected financial information for current and previous years of taxpayers engaged in similar businesses or occupations, in order to select specific returns for audit.
2. Audit projects – The CRA often tests the compliance of a particular group of taxpayers, particularly if there is reason to believe that there is significant non-compliance within a group.
3. Leads – Leads for audits often are the result of other audits or investigations, as well as information from outside sources.
4. Secondary files – A business may be selected for audit if it is associated with another file that is being reviewed for audit, since the CRA often finds it convenient to look at all the records at the same time.

Should the CRA find errors in your GST/HST returns, you need not necessarily be concerned that it will result in a full income tax audit. Non-compliance in one tax area does not necessarily mean there is non-compliance in the other.

What to expect from an audit

CRA audits typically begin with an audit proposal letter setting out the scope of the audit, the period being audited, the timing of the audit, and what information the auditor will need in order to perform the review. Depending on the complexity of your computer system, the CRA often sends an information technology officer out to obtain the data electronically in advance of the audit so the audit can be conducted more efficiently.

The audit process itself begins with a meeting at your premises between the auditor and someone from the organization. This is usually the business owner and/or an internal accounting representative. We recommend also including your external accountant. The auditor often will ask many questions regarding the business in an effort to understand how income is earned and what types of expenses are incurred, and to assist in identifying potential risk areas for non-compliance.

The audited organization has the responsibility to keep adequate books and records, and to make those books and records, and any supporting documents, available in both paper and electronic form.

The organization's representative must also be available to provide explanations to the auditor's questions. The days of thinking you could give an auditor a shoebox of receipts and let him or her sort through it no longer exist. Such an approach likely will result in a denial of your input tax credits and a negative audit result.

At this point in the process, the auditor will review your records and related documents, identify issues, and discuss those issues with you. The auditor will then prepare an audit proposal letter outlining any proposed adjustments and the rationale for them. You will then have 30 days to respond to the proposal with further details, additional supporting documentation, and your own proposals for resolving any outstanding issues.

After the 30 days, the Notice of Assessment or Notice of Reassessment will be issued to adjust your return. If you still disagree with your assessment or reassessment, you will have 90 days to file a notice of objection.

Payment

GST/HST is considered to be money held in trust, and so any assessment of tax is due when assessed. If the adjustment results in additional tax owing, there likely will be interest charges as well. In contrast to the corporate tax structure, GST/HST must be paid in full even while an appeal is underway. This requirement can create an onerous cash flow burden for an organization. It is thus important to deal with any issues in advance of the assessment being issued.

Pre-assessment reviews and audits can be stressful for any organization. They take time and resources away from the business focus and can result in costly adjustments. It is important to obtain tax advice whenever you deal with the CRA. Be sure to contact your Collins Barrow adviser for assistance in advance of an audit so we can help to minimize the negative tax consequences. §

The "Dark Path": Subsection 15(1) of THE INCOME TAX ACT

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There are many provisions in Canada's Income Tax Act (ITA) that are cause for concern for the unwary taxpayer. However, few have the broadness of application or the potential for damage of subsection 15(1).

The Canada Revenue Agency (CRA) has a number of provisions in the ITA to prevent shareholders from extracting wealth from a corporation without attracting income tax. Subsection 15(1) is, in many respects, a catch-all. It provides generally that, where a corporation has conferred a benefit on a shareholder, the value of that benefit will be included as income to that shareholder. The amount, or value, of the benefit is taxed as regular income to the shareholder in the year the benefit is conferred. The provision also applies to a person contemplating becoming a shareholder.

Staying in the light

Generally, when shareholders (particularly of private corporations) extract wealth from their corporations, they do so in the form of employment remuneration (salary, wages and bonuses), investment income (dividends or interest), or an assortment of methodologies sanctioned by the ITA (private pension plan contributions and private health service plans (PHSPs), to name a few). These approaches are, by and large, well-established and generate few concerns if executed properly.

In many cases, shareholders will draw on funds owed to them from their corporations out of their shareholder's loan accounts. A shareholder's loan account is somewhat akin to a kitchen sink in that it is a repository for all contributions made by a shareholder to a corporation, less draws taken by the shareholder.

Contributions to the account may be in the form of unpaid dividends or bonuses, cash contributions, or operating expenses paid for the corporation. Draws may be of cash, personal expenses paid by the corporation, or the value of corporate assets used by the shareholder. Generally, one will have strayed and started down the "dark path" when the values of these draws are not properly charged to the shareholder's loan account.

Knowns and unknowns

There are three important definitions relevant to the concept of a shareholder benefit.

First, the term "shareholder" is defined as a person (individual or corporation) who is entitled to receive payment of a dividend from the corporation. The quantum of the shareholdings is not, in itself, an issue.

Second, there is no definition of "benefit" in the ITA. Accordingly, the term has received broad interpretation, covering all manner of transactions between shareholders and their corporations. Taxable benefits can include:

- Personal use of corporate assets (e.g. real estate, aircraft, horses)
- Corporate payment of personal expenses
- Gifts to shareholders' relatives
- Inadequate consideration for sale of corporate assets
- Travel reward points
- Excessive payments under PHSPs

Finally, the "value" of the benefit must be established. This is by far the most subjective and contested of the three concepts. The CRA's position, that the value of the benefit is equal to its fair market value, raises issues concerning the determination of that fair market value. In some cases, the CRA's valuation approach to the personal use of corporate assets can lead to the value of the benefit greatly exceeding what the property could have earned in the form of rent from the asset in question.

The end of the road

The application of subsection 15(1) to a transaction can create some unpleasant tax consequences. Not only is the amount of the benefit taxed to the individual at the applicable marginal tax rates, there may be no deduction to the corporation for the amount, even if the benefit is repaid by the shareholder.

For example, in a situation where a personal shareholder expense is paid for and deducted by the corporation, not only will the deduction be disallowed to the corporation, but the value of the benefit will be taxed to the shareholder as well. For an investment corporation in the province of Alberta, say, this could create an initial combined tax liability at 83.67% the value of the benefit. Once penalties and interest are added, an assessment under subsection 15(1) can easily generate a tax liability equal to the value of the benefit.

GST liabilities can also result in situations where subsection 15(1) applies.

Illuminating

There may be ways to avoid an assessment under subsection 15(1). No "benefit" will arise from a bona fide business transaction between the shareholder and the corporation. As well, if one can demonstrate that the benefit arose as a function of employment, as opposed to shareholding, the income tax consequences can be mitigated and in some situations extinguished.

Further, there are certain exceptions in the ITA to the subsection 15(1) income inclusion, though they tend to exist only as a function of some other section of the ITA catching and taxing the transaction. Further, on appeal, certain arguments (like being a victim of unintended bookkeeping errors) have been occasionally, but certainly not consistently, successful in mitigating the damage.

Shareholders of private corporations should be aware of situations to which subsection 15(1) may apply. Be sure to ask your Collins Barrow adviser how to stay off the "dark path." §

Take Advantage of

NONREFUNDABLE TAX CREDITS

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With personal tax return season just around the corner, several new nonrefundable tax credits previously announced in the 2011 Federal Budget will be coming into effect. In addition, there are numerous other tax credits available to help reduce your income tax payable. It is worthwhile being aware of these credits as you assemble the information for your 2011 personal income tax return to ensure you maximize any available claims.

Children's art tax credit

The new children's art tax credit is available for children under 16 years of age (under 18 years of age if they qualify for the disability tax credit). Activities eligible for the credit will include:

- Supervised activities, suitable for children, that contribute to the development of creative skills or expertise in an artistic or cultural activity
- Activities that provide a substantial focus on the wilderness and natural environment
- Activities that help children develop and use particular intellectual skills
- Activities that provide structured interaction among children, where supervisors teach children to develop interpersonal skills or provide enrichment or tutoring in academic subjects

To be eligible, the activity must be either a weekly program lasting a minimum of eight consecutive weeks or, in the case of children's camps, a program lasting a minimum of five consecutive days.

You may claim up to $500 in such eligible expenses, creating a tax reduction of up to $75.

Family caregiver tax credit

While this new tax credit does not come into effect until 2012, it will provide an additional $2,000 tax credit for caregivers of dependants as an enhancement of the spousal or common-law partner credit, child tax credit, eligible dependant credit, caregiver credit or infirm dependant credit. One credit per dependant is available and will be phased out based on the dependant's net income.

Now let's consider some previously existing tax credits.

Children's fitness tax credit

Introduced in 2007, this tax credit allows taxpayers to claim up to $500 in fees paid for a child for eligible physical programs (a spouse's child or common-law spouse's child will also qualify). To qualify for this tax credit, the program must:

- Be ongoing (either a minimum of eight consecutive weeks or, for children's camps, five consecutive days)
- Be supervised
- Be suitable for children
- Require a significant amount of physical activity that contributes to cardiorespiratory endurance, plus one or more of muscular strength, muscular endurance, flexibility and balance

The following activities do not qualify:

- Activities in which riding in or on a motorized vehicle is an essential part
- Self-directed (unsupervised) activities
- Activities that are part of a regular school program
- Sports-academic programs

Fees paid by parents for accommodation, travel, food or beverages (e.g. room and board at a fitness camp) also do not qualify.

Amount for an eligible dependant

This tax credit is available to single, divorced or separated taxpayers supporting an eligible dependant. The restrictions on claiming this tax credit include:

- The child must be under 18, unless mentally or physically infirm
- Only one dependant may be claimed per taxpayer
- Only one claimant is entitled to the credit

If the taxpayer separated from his or her spouse during the year, the parent paying support may either claim the tax credit (assuming the other spouse has not) or claim a deduction for spousal support paid.

After the year of separation, only the parent with whom the child lives may claim this amount, and only if that parent is not paying support. It should be noted that cooperation with respect to the application of this tax credit is key to improving both spouses' financial positions. For example, if there are two or more children, each parent could claim one child (unless one parent is paying child support). The ability to share this tax credit is a factor that should be considered for inclusion in a separation agreement.

Spouse or common-law partner tax credit

Taxpayers can claim this amount if, at any time during the year, they supported a spouse or common law partner whose net income was below a specified amount ($10,382 in 2011).

Caregiver amount

If you maintained a dwelling in which you and one or more of your dependants lived, you may be able to claim this tax credit for each dependant (e.g. child, grandchild, parent, grandparent, sibling, aunt, uncle, niece, nephew). In addition, each dependant must have:

- Been 18 years or older at the time he or she lived with you
- Had income of less than $18,906 in 2011
- Been dependant on you due to a mental or physical impairment, or have been your or your spouse's or common-law spouse's parent or grandparent. If the claim is being made for a parent, he or she must have been 65 years or older during the taxation year

If you were required to make support payments for any of these dependants, you are not eligible for this credit unless you were separated or divorced for only part of the taxation year. In that case, you may either claim the caregiver amount or deduct any support payments you made.

Disability tax credit

If you have had a prolonged (12 months or longer) severe mental or physical impairment, you may be able to claim the disability tax credit if you meet certain conditions and obtain a certificate (Form T2201) from a qualified medical practitioner. If the Canada Revenue Agency accepts your claim, you may also be eligible to set up a Registered Disability Savings Plan to assist you with funding future living costs and to obtain matching grants from the federal government.

Be aware that these nonrefundable tax credits will only reduce personal income tax otherwise payable; they will not generate a refund if no tax is payable. The figures noted here refer to the federal component only. Most provinces offer similar credits but the particulars may vary from province to province.

If you are eligible for any of these tax credits and have not applied for them in the past, you can apply for them for up to the last 10 taxation years by making a “fairness request” to the Canada Revenue Agency. Contact your Collins Barrow adviser for more information and to ensure you claim all the tax credits for which you are eligible. §

Collins Barrow publishes *Tax Alert* quarterly for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While *Tax Alert* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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