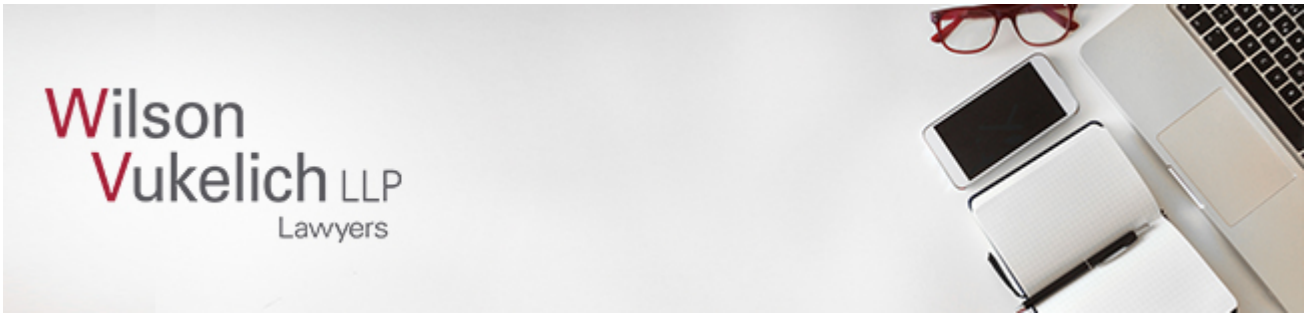

Top Tax Decisions of 2022 for Owner-Managed Businesses

January 2023 Tax Alert

As we start off the new year, it is helpful to review some important tax decisions from the Tax Court of Canada and the Federal Court of Appeal.

The tax dispute process remains a long and slow process. The CRA continues to deal with staffing issues and anticipates it taking a year to respond to medium complexity assessment objections. The Tax Court of Canada faces a continued backlog, with matters in queue for a hearing taking approximately 2 years to be assigned a hearing date. However, matters are still moving ahead (albeit slowly) and the Courts continue to issue decisions of significance.

Automatically Charged Gratuities Will Trigger HST Obligations

Subject to certain exceptions, businesses are required to charge and remit HST in regards to the supply of taxable services. For the most part, a tip or gratuity is not subject to HST, as it is a non-obligated payment. It is merely given as an expression of gratitude. However, where the tip or gratuity is imposed by the business, then it is subject to HST.

In the matter of *1410109 Ontario Ltd. v. The King,* the taxpayer operated a banquet hall. The hall was primarily booked for

Authors

Christine Ashton
905-940-0526
cashton@wvllp.ca

Avery Kalpin
905-944-2950
akalpin@wvllp.ca

Our Tax Lawyers


Josh Harnett


Robert Martini


Avery Kalpin

Our Tax Litigators


Christine Ashton


Doug Langley

weddings and celebrations. The taxpayer would provide the hall, meal service, bar service, etc. In its contracts with its patrons, it was provided that patrons would be subject to an automatic 15% gratuity. If there was an issue with the services, the price would be reduced, but the gratuity would remain in place. The taxpayer did not charge or remit HST on this automatic gratuity. In review, the Tax Court held that as the gratuity was non-negotiable, pre-calculated, and based on the amount of taxable services, it was indistinguishable for other taxable services, and thus subject to HST. As such, the taxpayer was held as having failed to have remitted HST.

In light of this decision, businesses should consider whether they are charging gratuities that may be subject to HST. To avoid HST obligations, businesses may wish to ensure it is clear that proposed fixed gratuities are discretionary or negotiable, in particular if there is an issue with the services.

Ensuring the Business Can Claim Its Expenses

A business may incur a variety of expenses, which will then be claimed with its annual tax return. However, in order to avoid these proper expenses being subsequently disallowed, it is important that proper books and records are maintained. For example, this will include purchase orders, invoices, mileage logs, receipts (not simply credit card statements), etc.

In the matter of *Brand v. Canada,* the taxpayer earned income through three streams: i) as a contractor for Bombardier; ii) as a cottage country realtor; and iii) as the owner of a powersports apparel company. The taxpayer often mingled the operations of these three businesses and was casual in regards to his books and records. The CRA disallowed various expenses in regards to these three income streams. Before the Tax Court, the taxpayer sought to have the assessment vacated and the expenses allowed. However, the Tax Court confirmed that the state of the books and records rendered it so that the expenses could not be allowed. For example, the taxpayer only had estimate of mileage, created by his bookkeeper further to the audit, as opposed to

actual mileage logs. As such, the appeal was dismissed and the assessment upheld.

Employees Claiming Their Employment Related Expenses

Pursuant to ss. 8(1) of the *Income Tax Act,* employees can claim certain expenses where it is further to their employment. To ensure employees can easily claim expenses, employers will often confirm that the expenses are required in the employment agreement and confirm the expenses by way of a T2200.

In the matter of *McCullough v Canada*¸ the taxpayer was employed as an industrial engineer and, due to a temporary change in duties, had regularly travelled to his employer's US office, which was over 8 hours away. The taxpayer claimed expenses in regards to lodging, meals, entertainment, and motor vehicle. In review, the Tax Court confirmed that the employee could claim the expenses as he was originally required to work away from the usual place of business in Lakehurst, Ontario.

Further to the above, employers should be mindful whether the expenses their employees are incurred are properly confirmed and documented, so that they can be claimed.

Gross Negligence Penalties: Regularly Assessed, But Not Always with Merit

Further to audits, the CRA is regularly assessing gross negligence penalties. These penalties can be substantial, amount to 50% of the tax liability, plus interest. However, while the CRA may assess the penalties, this does not mean it will be able to discharge its burden to establish the penalties were with merit.

In the matter of *Khanna v Canada,* the taxpayers were married mortgage brokers and were assessed taxes, interest, and penalties based on underreporting income in excess of $250,000. Before the Tax Court, evidence was led regarding whether the husband had negligently misrepresented his income. However, no evidence was led regarding whether the wife had negligently

misrepresented her income. The Tax Court confirmed the assessments and the wife appealed the decision to the Federal Court of Appeal. On appeal, the Federal Court of Appeal confirmed that the Minister had not met its burden of establishing, in regards to the wife, that she was grossly negligent. Accordingly, the appeal was allowed in regards to the wife.

In review, this decision represents an important reminder for taxpayers to remember that (unlike with regards to taxes) for gross negligence penalties, the burden rests with the Minister and the burden is substantial. If the taxpayer was not grossly negligent (e.g. wilfully blind), assessed penalties should be disputed.

Defending Against Director Liability: Ensuring a Proper Resignation

When a corporation is indebted to the CRA, its directors can be held liable and assessed accordingly. To avoid potential liability, directors have two defences: i) establishing due diligence (that they took all reasonable steps to avoid the tax debt); and ii) having resigned as a director. If a director resigns, then the CRA will only have two years to assess them under the *Income Tax Act* and the *Excise Tax Act.* However, if a director resigns, they must do it properly and they must also ensure that they do not remain as an unofficial or effective director (known as a de facto director).

In *Zvilna v Canada*, the issue was whether the director taxpayer had resigned more than two years prior to the director assessment, thus rendering the CRA statute barred. The taxpayer maintained that he had initially resigned verbally, pursuant to a draft separation agreement with his wife/co-director. Several years after the separation agreement was prepared, the taxpayer finally signed off on the paperwork confirming that he had resigned. In review, the Tax Court held that the director taxpayer had not initially resigned, as a verbal resignation is insufficient and the separation agreement only provided a promise to resign (it was

not a resignation itself). However, when the taxpayer formally papered his resignation six years later, then, at that time, he had resigned. As such, the assessments were issued more than two years after the director taxpayer had resigned and were statute barred.

In review, if a director wishes to start the limitation clock on director liability, it is important that they properly resign in writing, which involves formally notifying the remaining directors, ensuring the relevant government agencies are also notified, and that no effective-director roles are substantially undertaken.

Limitations on the Adversarial Relationship in Tax Court

The Tax Court is a statutory court, which means that its decisions are generally only based on whether the *Income Tax Act* and the *Excise Tax Act* are abided by. The Tax Court generally does not consider justice, fairness, etc. However, this does not mean that such principals will not be considered where there have been violations of Orders and the Rules. In the recent Tax Court decision of *Choptiany v The King*, the Court issued a scathing condemnation of the CRA's conduct and allowed the taxpayer's appeals, with costs. The inappropriate conduct included ignoring aspects of a Court's production order, inappropriate and intentionally not disclosing a criminal investigation of one of the taxpayers, and repeatedly breaching the Rules by failing to have a knowledgeable and prepared representative at the examination. The Tax Court expressed that it was "deeply, deeply disturbed" by this conduct and allowed the appeal.

In review, while in an adversarial relationship, parties in tax disputes should still ensure that they comply with Orders and the Rules. Where the Minister has failed to do so, a taxpayer may be able to rely on these breaches in seeking the appeal to be allowed. Otherwise though, taxpayers should not expect the concepts of justice or fairness to be relevant.

In review of the above decisions, owner-managed businesses must ensure that they are properly handling matters, so that they

are well-prepared in the event of a tax dispute. Where a tax dispute arises, it is important that it be addressed strategically and in light of the evolving caselaw. For more information or to discuss any current tax disputes, please contact our firm.

About Us

Our law firm is your strategic business partner.

For over 30 years, WV LLP has been a leader in business and tax law. Since its inception, WV LLP has been known for working strategically with our clients, using our knowledge and experience to provide prompt, practical and cost-effective solutions.

As a full service firm with over 25 lawyers, we are able to deliver practical, value-added legal services to address our clients' business needs. We recognize that there are many facets to a business and, as a law firm, we are ready to assist in all areas.

LEARN MORE

Our Legal Insights

Our law firm is here to keep you up to date in regards to legal developments and strategies.

We regularly host webinars, to ensure our clients are informed about the latest legal developments and strategies. We also have a library of on-demand webinars available for clients to view, at their leisure.

LEARN MORE

905.940.8700 **information@wvllp.ca**

60 Columbia Way, 7th Floor | Markham, Ontario | Canada L3R 0C9
