GALLOWAY BOTTESELLE & COMPANY
Professional Services Group

The Abacus
ISSUE 59
PROFESSIONAL **STRENGTH** PERSONAL **SERVICE** PRACTICAL **SOLUTIONS**

US citizens beware!
Your bank is telling on you

The long arm of the US government continues to reach far beyond its border

IN FEBRUARY 2014, Canada and the United States signed an *'information exchange'* agreement under which Canadian banks, brokerages and other financial institutions will report information to the Canada Revenue Agency (CRA), which in turn will start sharing this information with the Internal Revenue Service (IRS) beginning in 2015. The Canadian government also introduced amendments to the Canadian Income Tax Act to require this reporting.

'US persons'

The information being reported is of *'US persons'* who own—or have any interest in—accounts at these institutions. *'US persons'* include:

- any US citizen, even if the person is also a Canadian citizen;
- anyone who holds a US green card (permanent residency card), even if they no longer live in the US;
- US incorporated companies; and
- various other entities.

THIS INFORMATION EXCHANGE is being done to comply with the US Foreign Account Tax Compliance Act (FATCA). The US requires its citizens to file tax returns and pay tax even if they are not resident in the United States. (The US is the only country in the world that does this, except for Eritrea.) Although US citizens in Canada have a variety of mechanisms to avoid double tax on most of their income, there are many situations where they will have to pay additional US tax.

In order to *'find'* US citizens living outside the United States, the US has introduced FATCA. If Canada had not signed the information exchange agreement, Canadian financial institutions would have been required to report information about *'US persons'* directly to the IRS, and if any institution did not comply, all payments from the US to accounts at that institution would be subject to a 30% withholding tax. With the information exchange agreement, the withholding tax will not apply—except in some cases of serious long-term non-compliance.

Dual citizens

FATCA could be quite intrusive for dual citizens. If by accident you were born in the US, or you were born in Canada but had an American parent, you may be a US citizen, even if you have never had a US passport. Under the new agreement, your bank (and brokerage, etc.) will now be required to identify you if you are a *'US person'*. If so, your bank will report this to the CRA, which will in turn report it to the IRS. In due course you can expect the IRS to start demanding tax

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‘Deemed disposition‘ rules

DEATH AND TAXES —IT IS OFTEN SAID THAT THEY ARE THE ONLY THINGS THAT ARE CERTAIN IN THIS WORLD. FURTHERMORE, IN MOST COUNTRIES, INCLUDING CANADA, DEATH OFTEN LEADS TO MORE TAXES.

MANY COUNTRIES have an inheritance tax, estate tax or succession tax. Canada does not. (Most Canadian provinces impose probate fees or *‘estate administration taxes’*, but they never exceed 1.5% of the estate). However, our income tax system contains certain *‘deemed disposition’* rules that effectively tax accrued gains at the time of one’s death.

Basically, when you die, you are deemed to have sold all your capital properties including shares in your own private company (and certain other properties like land inventory) for fair market value (FMV) proceeds, at the instant before death. The person who acquires or inherits the property as a consequence of your death will have a cost in the property equal to that FMV.

Capital gain

If the FMV of the property **exceeds** your cost of the property, you will realize a capital gain; half of that will be a taxable capital gain reported on your *‘terminal’* return for the year of your death, with the resulting tax payable by your estate.

Capital loss

If the FMV is **less** than the cost, you will have a capital loss.

When capital loss exceeds capital gain

If the capital losses in your terminal return exceed the capital gains, one-half of the excess is a net capital loss. Net capital losses can normally be deducted only against taxable capital gains. However, in the year of death and the preceding year, they serve to offset taxable capital gains and all other sources of income.

If your estate realizes capital losses in its first taxation year in excess of capital gains, the excess losses can be carried back to your final taxation year and used on your terminal return. These capital losses can serve to offset any capital gains in the year of death, including those arising under the deemed disposition at FMV rule.

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Wrong information from CRA —but company still liable for not collecting GST

AROUND THE COURTS

The recent Tax Court decision in Smart Net Systems Ltd. is an unfortunate case of a company that was given wrong information by the CRA—and did not collect GST on sale of goods that turned out to be taxable.

THE CASE
SMART NET

Smart Net, located on Vancouver Island in Comox, BC, imported and sold various agricultural and fish netting products. The fish nets were zero-rated (i.e., free of GST) because commercial fish nets are listed in the GST Regulations that apply for this purpose. Agricultural netting, however, is not listed in the Regulations and is not zero-rated.

When Smart Net began importing agricultural netting (used to protect crops), its owner contacted the CRA and was assured—wrongly— that this netting was zero-rated. As a result, Smart Net did not collect GST on these sales.

THE DECISION
PAY UP!

Eventually Smart Net was audited, and the CRA assessed it for some $17,000 of GST not collected and remitted on the netting. The CRA waived all interest and penalty on the assessment, evidently believing that Smart Net had asked the CRA for direction and been given wrong advice. However, it would not back down from the assessment of the GST itself.

THE APPEAL
DISMISSED

Smart Net appealed to the Tax Court of Canada, but the Tax Court dismissed the appeal.

As the Courts have established in many such cases, receiving wrong information from the CRA does not affect the correctness of a tax assessment. Smart Net might be able to sue the CRA for damages (for negligence in providing wrong advice), but it could not escape the assessment for failing to collect GST on its sales of agricultural netting.

In this situation, Smart Net should also identify whether it can bill the GST to its customers. To the extent it made large sales to GST-registered customers who can claim input tax credits, the customers should not mind paying the GST to Smart Net since they will recover it. However, if Smart Net has many small customers, this approach will not be practical.

This is a case where the CRA auditor should have acted more reasonably and simply instructed Smart Net to start collecting and remitting GST on agricultural netting in the future. Once the assessment was issued, neither the CRA Appeals Officer nor the Tax Court judge had the legal authority to cancel it, but the auditor could have simply not assessed in the first place. Unfortunately, the CRA in recent years has become much less reasonable in such situations.

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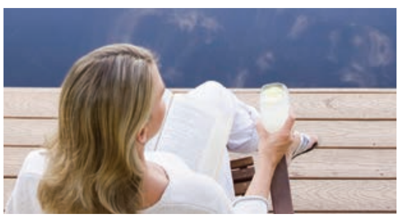
returns from you. Even if no tax is payable, you may be subject to severe penalties for not filing the returns. You may also be subject to very severe penalties, such as $10,000 per account, for not reporting all your Canadian bank and brokerage accounts to the US government under the Bank Secrecy Act. These rules were introduced to catch hidden Swiss bank accounts, but they apply equally to your regular Canadian chequing or savings account.

Canadians with US assets



IF YOU ARE A CANADIAN citizen and live in Canada, the IRS may not be able to enforce collection of any tax or penalties that you owe. However, if you have any assets in the US, or if you ever travel to the US, having a large tax debt to the IRS will cause you a lot of trouble. If your Canadian passport shows that you were born in the US, American immigration officials at the border will tell you to get a US passport or you will not be allowed entry next time. And of course, when you apply for a US passport, the IRS is notified that you exist.

US persons who have not been filing US tax returns and reporting their financial accounts to the American government should get professional advice as soon as possible on how best to comply voluntarily. By complying voluntarily you may reduce or eliminate costly penalties the IRS could assess.

TAXATION ON DEATH CONT'D FROM P. 2

Property left to spouse or common-law partner

IF THE PROPERTY IS LEFT TO YOUR SPOUSE or common-law partner (or a qualifying spousal or common-law partner trust), the property is deemed to be disposed of at its tax cost rather than its FMV. As a result, there will be no gain or loss and no tax payable by you on the deemed disposition. Your spouse will inherit the same tax cost in the property. This scenario is often referred to as a tax-free spousal rollover.

However, the estate trustee, executor or administrator of your estate can elect out of the spousal rollover on a property-by-property basis. If they elect out of the rollover, the property is subject to the regular deemed disposition rule at FMV proceeds. This election could be useful in the following circumstances if the property has:

- **an accrued loss**, so that the loss will be triggered in the year of death and can reduce tax otherwise payable on your terminal return;
- **an accrued gain**, but the gain can be offset by other capital losses on the terminal return. The spouse (or spouse trust) will inherit the property at a stepped-up cost equal to FMV; or
- **an accrued gain that can be offset** by your capital gains exemption, if any. This exemption allows up to $800,000 of capital gains (more after 2014) to be realized tax-free on dispositions of qualified small business corporation shares, and certain qualified farm or fishing property. The spouse will then inherit the property at a stepped-up cost at FMV.

Galloway Botteselle & Company

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PORTER HÉTU *INTERNATIONAL*
Professional Services Group

Brian M. Galloway, CFP, FCGA
E. Albert Botteselle, CGA, CFP
Brian R. Blamey, BA, CGA
David P. Van Gruen, CGA
Saskia N. Muller, BCOM, CGA
Selena G. Nisbet, BCOM, CGA

Maple Place Professional Centre
300 – 2000 West 12th Avenue
Vancouver (BC) V6J 2G2
TEL (604) 736-6591
FAX (604) 736-0152
EMAIL info@gbco.ca

VISIT US ONLINE **WWW.GBCO.CA**

THE ABACUS IS PUBLISHED BY
PORTER HÉTU *INTERNATIONAL*

COORDINATION Flora Hugon
DESIGN JAM Design
FRENCH TRANSLATION Noëlla Bordage
SEND COMMENTS/QUESTIONS TO FLORA HUGON fhugon@gbco.ca