

A Lesson in Record Keeping!

The Income Tax Act (Canada) requires you to keep all documents supporting your business activity; in an audit, the CRA will demand them.

Keep Everything

According to the Income Tax Act, taxpayers must keep "records and books of account ... together with every account and voucher necessary to verify the information contained therein" for a period of six years following the last taxation year to which they relate. For corporations, the start of the six-year period is the fiscal year; for individuals, the calendar year.

Show Us the Proof

An appeal ruling before the Tax Court of Canada, July 2013, reinforces the need to maintain documentation. In summary here is what led to the ruling:

- ✓ The taxpayer acquired a rental property for \$172,000 in 2002, and sold it in 2007, for \$285,000 but declared no capital gain in his 2007 tax return.
- ✓ In 2010, the Canada Revenue Agency (CRA) advised the taxpayer that his return for 2007 was under review and that he was required to provide copies of the contract of purchase and sale, a statement of the capital cost allowance claimed over the years the property was owned, a list of any expenses related to the purchase and sale as well as the receipts for those expenses.
- ✓ In a late filing of his 2008 tax return, the taxpayer declared a capital gain of \$41,572 and a taxable capital gain of \$20,786 (i.e., 50% of the capital gain). The taxpayer said he was declaring the capital gain in 2008 because, despite having signed the sale agreement in December 2007, disagreements with the new purchaser made the sale "uncertain and incomplete" until March 2008, when the disagreements were amicably settled.
- ✓ Included in the taxpayer's capital gains calculation was \$52,810 in renovation expenses claimed to have been incurred before he actually acquired possession of the property (i.e., between April and November 2002). (The addition of this amount to the adjusted cost base (ACB) would have reduced the capital gain when the property was sold.)
- ✓ The CRA rejected the renovation expenses because the taxpayer provided no vouchers. The taxpayer said he had stored the receipts in his basement but they had been lost in a flood in 2008. He was unable to explain why the existence and loss of these receipts had not been brought to the attention of the CRA during the audit, discovery or the appeal. The taxpayer said he had made no insurance claim for the loss because he did not want to increase his future insurance premiums. He therefore also had no documents from the insurance company attesting to his loss.
- ✓ The appeals judge ruled that the sale had taken place in 2007 since it had taken place by deed of sale before a notary in December 2007, and had also been registered in the official land registry in December.
- ✓ The judge also ruled that the period between the date of purchase (November 14, 2002) and the date of sale (December 18, 2007) was not six years and, in any case, the Income Tax Act required the taxpayer to keep records of any claims until the expiry of the appeals process, which the taxpayer had not done.
- ✓ The appeal was dismissed with costs to the taxpayer.

Lessons

Referring to other cases, the judge emphasized that, since our tax system is based on personal self monitoring, the burden of proof for deductions and claims lies with the taxpayer. Just keeping notes is not enough; documents are required. If the taxpayer had been able to produce records of his renovation expenses (and if they had been accepted by the CRA), he would have saved himself a significant amount in taxable capital gains and legal costs. The addition of the claimed \$52,810 in renovation expenses to the \$172,000 purchase price would have given him a capital gain of \$60,190. Instead, he incurred a capital gain of \$113,000. The taxpayer's inability to produce his expense records cost him \$26,405 in taxable capital gains.

What about Your Past?

Prior to February 22, 1994, there existed a cumulative capital gains exemption of \$100,000. If this amount was not fully used by the February 22, 1994, deadline, taxpayers could use any unused amount to revalue capital

property. Effectively, the taxable capital gain on any taxable capital property sold thereafter would be reduced by the election amount of 1994. Documentation to support 1994 valuations may be required.

Consider the following types of transactions that may need to be substantiated with adequate documentation years after they have occurred:

- ✓ If you purchase shares of a corporation from a third party, the ACB of those shares will not be the paid in capital on the balance sheet. Shares could be purchased at different times for different amounts.
- ✓ If you have investments in income trusts, part of the monthly payments are usually return of capital which reduces the ACB of the investment.
- ✓ When calculating the ACB of a partnership, you have to take into account the partners' taxable income, which is often different from the accounting income.
- ✓ Corporations that incur a non-capital loss may apply to reduce all types of income in the three taxation years prior to, and the seven taxation years following, the loss (10 years for taxation years ending after March 22, 2005). It would appear from the Tax Court ruling that application of non-capital losses 10 years back would subject the applicant to another six years of record keeping in the event that CRA wished to audit the taxable years.

As a result of the 2013 Tax Court rulings, individual and corporate taxpayers should consider the following:

- ✓ Locate the original documentation pertaining to any capital property.
- ✓ Review the record destruction policy to ensure you are retaining pertinent records.
- ✓ Contact your lawyer, accountant, real estate advisor, appraiser or other professional to determine whether they have copies of any of your records that may be required. If possible, get the originals and leave them copies.
- ✓ Keep in mind that professionals change firms, die, or sell their business to others. If your professional is no longer available, review past tax returns and statements to determine whether there are any issues that may require documentation held by their predecessors. Ask your current professional if they have documentation for the years in question.
- ✓ Consult with your professional about losses and their applicability to prior years' taxable income to determine whether the time and cost of a potential CRA audit is worth the dollars that may be recovered.
- ✓ Establish a relationship with a CPA firm. Your CPA will be attentive to maintaining historical information.
- ✓ Maintain originals of all documents. After all, as noted above, it is your responsibility to produce the necessary documents to support your claim(s).

Get It All Together

As you approach retirement and plan to sell the company or transfer ownership to others, you will need to have documentary evidence of past transactions to ensure any tax liability is kept to a minimum. Owner-managers should make reviewing the past and gathering the required information a priority.

On The Horizon

The Partners and Staff wish to welcome back Marie-Soleil Lee, Wilson Li, Chantal Bergeron and Christina Yee for their 2nd Co-op Term through the University of Ottawa. Welcome to Kyle Royer who is a Co-op student through Carleton University who previously completed co-op work terms with the former DNTW Ottawa location. We are also very pleased to welcome 1st Co-op Term students Rachel McDonald, Siyuan Fu and Mary Le from the University of Ottawa and Anthony Poon from Carleton University. Finally, welcome also to Alexandra Brunette-D'Souza who will be working on a term basis with us from January to April.