

Yes, the Taxman: sometimes it feel like you're working for no one but him; especially if you are a high income earner. Therefore, it's no surprise that income tax payers:

Dealing with the Taxman - Proposals to Canada Revenue Agency

- Find ways to shelter their income. For many self-employed individuals, particularly some professionals, they do this by investing in tax shelters. However, when one's tax shelters get disallowed by Canada Revenue Agency and a reassessment is issued, what can be done if the tax bill can't be paid?
- Fail to remit income tax installments altogether, and end up with significant penalties and interest.

When the assessment or reassessment comes in, some tax debtors are inclined to do one of the following:

- 1. Ignore the tax debt**, hoping that CRA will never take action to collect it. This of course, rarely happens and the agency may eventually take collection action by garnisheeing wages or liening the debtor's assets.
 - 2. File an appeal.** However, many appeals are unsuccessful.
 - 3. Make an application for Fairness.** Within each Tax Services Office there exists a committee responsible for reviewing taxpayers' requests to waive penalties and interest accrued due to late payment of income tax. Adjustments are made for compelling reasons on compassionate or equitable grounds, or circumstances beyond the control of the taxpayer (e.g., serious illness or accident, incorrect information supplied by CRA, a natural disaster, strike, or civil disobedience).¹
- Many such applications are not successful as the criteria required to have the application granted by CRA are onerous.
- 4. Borrow money** from friends or family to pay the outstanding tax bill. However, for many, this may not be a viable option.
 - 5. File for bankruptcy.** However, for some professionals, this is not a viable option from a social standpoint and may affect their ability to practice their profession (i.e., lawyers and chartered accountants).

6. Make a settlement with CRA by way of a proposal under the Bankruptcy and Insolvency Act ("BIA"). This article will deal with issues particular to proposals made to CRA. The mechanics of the proposal process has been described in previous articles entitled "Let's Make A Deal - Proposals to Creditors" and "Division I Proposals - Let's Make A Deal (Part 2)" and will not be repeated here. The reader is encouraged to review those articles before proceeding further.

Here is a scenario that we often encounter in the insolvency profession: Mr. X is a prominent self-employed lawyer in his community and earns a significant annual income. Approximately two years ago, Mr. X, on the advice of his investment advisor, had invested in a tax shelter, being a limited partnership carrying on a business which was the manufacturing and selling of tanning beds to South America.

The business was subsequently investigated by the RCMP and CRA. The investigation concluded that the business was a fraud upon the investors and never truly existed. Hundreds of limited partners, each lost their investment, including Mr. X. Mr. X was subsequently reassessed by CRA for the income tax years relating to the deductions taken under the tax shelter. He was found to owe \$800,000 in income taxes, penalties and interest. Mr. X upon consulting with his accountant found himself to be insolvent, even though CRA is his only creditor.

Although Mr. X's friends and family were willing to lend him some money, it would not have been sufficient to pay off the tax bill. Mr. X considered filing for bankruptcy, but he did not want any stigma that might be associated with that option. Moreover, as he had control of trust funds in his law practice, he wouldn't be able to continue his routine practice if he filed for bankruptcy.

Mr. X eventually met with a bankruptcy trustee and discussed the option of filing a proposal under the BIA.

There a number of factors to be considered in drafting any successful proposal which involves CRA as a creditor, and they are discussed below.

Disclosure of Information

A major success factor in dealing with CRA is communication. CRA requires detailed information on the debtor's financial situation, the causes of his difficulties and the steps taken by him to get back on solid financial ground. CRA needs to be convinced that the debtor is not

abusing the process, that the proposal is the best deal possible and that it will result in a greater return than CRA would realize by forcing the debtor into bankruptcy.

Amount to Offer

CRA will often start negotiating from the standpoint of being paid "100 cents on the dollar" of what it's owed. This of course is unrealistic given the financial circumstances of most tax debtors. However, it is an indication of how tough CRA will be in the negotiations and that it will expect a significant return from any proposal submitted.

The return expected by CRA will vary depending on the debtor's financial circumstances. In any event, CRA tries to resolve the situation as soon as possible so its representatives' time is not wasted and it can receive at least part of the tax owed in a timely manner. Therefore, it is essential to put one's best foot forward at the start by submitting a proposal that is fair and reasonable in the circumstances.

Required Provisions

There are a number of provisions required in a proposal prior to its acceptance by CRA:

1. Income tax installments and returns will have to be kept current going forward;
2. If applicable, GST collected and payroll taxes deducted will have to be remitted on a timely basis going forward;
3. The debtor will have to withdraw any appeal he has filed with respect to his (re)assessment; and
4. If applicable, payroll source deductions in arrears are required to be paid within 6 months after the approval of the proposal by the court, or within a timeframe mutually agreed to by the debtor and CRA.

Effect on Pre-Proposal Income Tax Debt

The Income Tax Act ("ITA") provides that upon bankruptcy, a debtor's tax year will be split in two: the pre-bankruptcy period and post-bankruptcy period. Therefore, in a bankruptcy scenario, income tax debt incurred within the calendar year up to the date of bankruptcy (i.e., pre-bankruptcy debt) will be discharged (i.e., no longer owing by the debtor).

The ITA contains no similar provisions for proposals. Therefore, until fairly recently, income tax liabilities incurred within the calendar year up to the time of the

proposal could conceivably become a post-proposal debt payable by the debtor.

To address this inconsistency, the Canadian Association of Insolvency and Restructuring Professionals (CAIRP) in December 2002 submitted a brief to the Department of Finance requesting an amendment to the ITA that would permit a deemed year-end in proposals.

Until the ITA is amended, both the CAIRP and CRA have agreed to institute the application of CAIRP-developed Standard of Professional Practice regarding the income tax debt of proposal debtors, effective February 1, 2004.

Under this Standard, the debtor files an income tax return for the calendar year up to the proposal date based on the estimated tax debt for this period. CRA subsequently files a proof of claim based on this pre-proposal return. Upon the successful completion of the proposal, the pre-proposal debt gets discharged.

It is important that the pre-proposal debt be estimated carefully; if this estimate turns out to be too low, CRA will add the missing amount to the post-proposal income tax liability.

Conclusion

If the trustee and debtor properly consider and address the factors reviewed in this article, then the resultant proposal should generate few questions for clarification or requests for further information by CRA. That will be a good indication of its acceptability to CRA and its ultimate success.

¹ Canada Revenue Agency Circular IC-92-2

Victor Fong, CMA, CIRP
Trustee in Bankruptcy
victor@fongpartners.com

Starting Over

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Fong and Partners Inc.
Trustee in Bankruptcy
Scarborough • Toronto • Brampton
T 416.260.3264 F 416.323.5248
www.startingovertoronto.com