



Victor Fong

Trouble with the Taxman

Because dentists are often subject to high levels of personal income tax, it's no surprise that they often seek ways to shelter their income. One method involves investing in tax shelters, but some shelters may be disallowed by the Canada Revenue Agency (CRA). In other cases, dentists may fail to remit income tax payments altogether, and end up faced with significant penalties and interest.

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

1. Ignore the debt, hoping that the CRA will never take action to collect it. This of course rarely happens and the agency may eventually garnishee wages or lien 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 the CRA, a natural disaster, strike, or civil disobedience). Many such applications are unsuccessful, because the criteria required to have the application granted by the CRA are too onerous.
4. Borrow money from friends or family to pay the outstanding tax bill. However, for many this may not be possible.
5. File for bankruptcy. This may also not be a viable option from a social standpoint.
6. Make a settlement with the CRA by way of a **proposal** under the *Bankruptcy and Insolvency Act* (BIA).

This article will deal with item No. 6 — settlements with the CRA through the proposal process. Let's look at a typical scenario:

Dr. Caps is a prominent dentist who earns a significant annual income. Approximately two years ago, Dr. Caps invested in a tax shelter — a limited partnership carrying

on a business of manufacturing and selling tanning beds in South America.

The business was subsequently investigated by the RCMP and the CRA, who concluded that it was a fraud and never truly existed. Hundreds of limited partners each lost their investment, including Dr. Caps. Dr. Caps was subsequently reassessed by the CRA for the income tax years relating to the deductions taken under the tax shelter. She was found to owe \$800,000 in income taxes, penalties and interest. Dr. Caps, upon consulting with her accountant, found herself to be insolvent, even though the CRA is her only creditor. Dr. Caps eventually met with a bankruptcy trustee and discussed the option of filing a proposal, known as a Division 1 Proposal, under the BIA.

What is a Division 1 Proposal?

This is a legal process available under the BIA that allows a debtor to facilitate a settlement with creditors and avoid bankruptcy with the assistance of a trustee in bankruptcy. A Division 1 Proposal provides a debtor with two distinct advantages:

1. Upon filing a proposal, a stay of proceedings is immediately in effect. The debtor essentially becomes creditor-proof; and
2. It may not be necessary to pay creditors 100 cents on the dollar. A proposal offered by the debtor may be acceptable to his/her creditors provided it can show that the return to creditors would be higher than in a bankruptcy scenario.

The debtor and the Trustee review the debtor's financial situation and determine what type of proposal can be made and whether it will be acceptable to the creditors.

There are generally no restrictions on what may be offered. However, in my experience, the most common proposal terms are as follows:

- The debtor will make monthly payments over several years to pay off the settlement amount.
- The debtor will make a lump sum settlement by borrowing from friends and family. If there is sufficient equity in his/her home, the debtor may be able to finance the settlement by way of a mortgage.

The following steps then take place:

- The proposal is drafted by the trustee, signed by the debtor along with other statutory documents and then filed with the Office of the Superintendent of Bankruptcy (OSB). Upon the filing of the proposal, a stay of proceedings is in effect, and the debtor becomes creditor-proof.
- The creditors review the proposal at a meeting called by the Trustee. At the meeting, the creditors vote either for or against the proposal. The approval of the proposal requires the support of: (1) a majority of the creditors present; and (2) two-thirds of the value of the claims filed by those creditors. If these voting criteria are not met, then the debtor is automatically declared bankrupt. In actual practice, the creditors' meeting is often a time for negotiating an acceptable proposal. If the creditors and the debtor mutually agree to amendments to the proposal, then the creditors approve the amended version.
- Once the creditors approve, the Trustee arranges for a bankruptcy court to review the proposal for fairness and to ensure that it complies with certain statutory requirements.
- Upon approval by the court, the debtor proceeds to fulfill the terms of the proposal. Once these are completed, the debtor is discharged from his/her debts.

Conclusion

The proposal offers a viable and attractive alternative to bankruptcy and has been steadily gaining popularity over the past several years. For a debtor, it provides flexibility, in that a repayment plan can be tailored to the debtor's ability to pay. It also minimizes the impact on the individual's credit rating. For a creditor, a proposal means he or she will receive more money than if the debtor was declared bankrupt. From a social perspective, the proposal process enables a debtor to repay creditors and encourages personal responsibility for the repayment of debts. 

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NOTE: The information in this article provides an overview rather than a complete analysis. It is not intended to, nor does it, provide legal advice with respect to specific problems. Circumstances alter cases, and you are advised to consult your professional advisor for particular situations.

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