CGA CERTIFIED GENERAL ACCOUNTANTS

Tax Newsletter

August 2014

By Richard Yasny, LLB., LLM.

How Do-It-Yourself Accounting can be Costly for Clients

Mr. Walker controlled a group of companies. He owned the shares of a holding corporation (Holdco), which owned the shares of an operating company (Opco). He loaned $400,000 to Holdco, which then loaned the money to Opco. In 2002 and 2003, Opco paid $50,500 into Mr. Walker's pension and his RRSP. But when Opco made these payments for Mr. Walker's benefit, it did not owe him money directly; it owed money to the Holdco he controlled. So, relying on *Income Tax Act* ss. 246(1) (indirect benefit rule), 6(1)(a) (employee benefit rule), and 15(1) (shareholder benefit rule), the CRA assessed Mr. Walker on the basis that the pension and RRSP payments were taxable benefits to him and not repayments of shareholder loans. He appealed the reassessments to the Tax Court of Canada, saying the Opco payments were non-taxable repayments of his shareholder advances. It really didn't matter whether Opco or Holdco owed him money; they were really both the same entity, he said. The Court, however, agreed with the CRA.

Mr. Walker represented himself; the corporate CFO was his witness. They made several arguments you have heard from, or made for, clients before. You will therefore likely want to make a note of this case (*Walker v. The Queen*, 2014 TCC 182), as it will help you explain to clients the importance of proper accounting for shareholder loans and repayments over a DIY approach.

Not considered a "simple mistake"

First, as often happens in these shareholder benefit cases, Opco had claimed the retirement payments as business expenses (which indicated they should be taxable to Mr. Walker and were not loan repayments). Mr. Walker and the CFO blamed the internal accounting staff, saying the deductions were mistakes that deviated from the normal practice of setting off the loan accounts. The Court rejected that excuse: "Neither Opco nor Holdco's debts were or have been reduced in either year; nor has any correcting entry, document, rectification order or other indication of the intention to correct the alleged error been adduced before the Court" (para. 9). Relying on *Chopp v. Canada*, 98 DTC 6014 (see CGA-Canada's *Tax Newsletter*, May 2014), the Court said that for a defence of simple mistake, a taxpayer must show that the error was accidental, while in this case, "the result arising from the alleged omission carries no obvious signs of absurdity or apparent error" (para. 10). (Although he didn't say so clearly, the judge seemed to imply that the Walker group could and should have corrected the mistake before going to Court, even after the reassessments.)

Separate entities can't be ignored

Mr. Walker argued that employees and customers saw the Walker Group as a single "interwoven enterprise," so the Court should do the same: ignore the division between Holdco and Opco and look at the retirement payments as if they came from the single entity. The judge refused to ignore the separate Holdco and Opco entities: "one cannot disclaim, inconsistently or when inconvenient, the very structure one has otherwise authorized, overseen and utilized." The judge said that either Opco should have paid money up through Holdco, or Holdco should have made the payments for Mr. Walker directly (para. 11).

Commercial reality can reduce the need for evidence, but cannot eliminate it

As is common among taxpayers, Mr. Walker complained that tax rules ignore the practicalities of daily business, where "it is unrealistic to expect owner/operated businesses to adhere to an intensive 'paper trail' standard in order to reflect every advance and repayment with written documents and receipts" (para. 7(c)). Mr. Walker said that the repayment of loans and advances was normal practice for the business, so the intent to repay could be presumed. But Justice Bocock rejected the defence that the absence of evidence was excusable here because such loans and repayments were normal practice for the business. In this case, the Court said, there was "no evidence … that in previous periods similar payments to either plan had been deducted from the Advances either contemporaneously or *post facto*: no retroactive adjustments; no cancelled cheques evidencing the purpose of such previous payments and no inter-company adjustments."

Mr. Walker also defended the corporate failure to correct the financial statements after the fact, saying that he was awaiting the outcome of the Court hearing. But by not having corrected the errors, said the judge, Mr. Walker lost the chance to use the corrected financial statements in his defence (para. 14). The Court's comments, surprisingly, suggest that it is wise to correct statements even after a reassessment, so that you could use the corrected statements in an objection and appeal.

Documentary evidence is required, although no written agreements

Mr. Walker said that it's unrealistic to expect "written agreements evidencing the advance and repayment of shareholder or related party debt" in "the small business world." Justice Bocock agreed, saying taxpayers could rely on "current adjusting entries in ledger accounts and year-end balance sheets" or an appropriate chain of cheques, receipts, or directions. But Mr. Walker didn't have any of these.

No interest relief in Tax Court

Finally, Mr. Walker argued, like many before him, that the interest charged on his assessment was unfair. But the Tax Court has no power to reduce interest, which applies automatically to assessed tax and penalties. (See *ITA* ss. 161(1) and (11).) To reduce assessed interest on grounds of fairness, Mr. Walker must apply to the CRA for "Taxpayer Relief," although that remedy seems unlikely in his case because it will be hard for him to say that the errors "result from circumstances beyond [his] control." (See CRA, IC07-1 "Taxpayer Relief Provisions," §§25 and 33.)

Help your clients protect themselves

In most cases, clients restrict your engagement to compilation reports and, perhaps, bookkeeping or accounting oversight. The *Walker* decision shows you can help clients avoid costly reassessments by checking their current and past tax reporting to find and correct lingering expense and loan errors. It can be a service to your clients to persuade them to spend the time (and fees) to check the appropriateness of claimed expenses and to ensure that draws from their corporations are properly recorded in the shareholder loan account. Although retroactive tax planning isn't allowed, retroactive accounting corrections are, especially if caught before a CRA audit.