10 Tips to Avoid a CRA Audit

Are you actively seeking an audit? Probably not. But if you were, Canada Revenue Agency (CRA) helpfully publishes alerts on its website that identify areas of concern for auditors and warn about actions and investments the agency is likely to investigate. Here are 10 red-flagged practices that could contribute to a CRA decision to audit your tax return.

1. Employment Expenses

The CRA is paying closer attention to employees who attempt to deduct employment expenses from their employment income. Employees are very limited in the types of expenses they can deduct. Those employees who choose to make a claim can expect questions from CRA.

2. Large Charitable Donations

The CRA seems to draw the line at cash donations in excess of $25,000, asking for additional information to substantiate the donor's claims.

3. Allowable Business Investment Loss (ABIL)

An ABIL occurs when a person disposes of debt or share of a small business corporation. The advantage of realizing an ABIL over an ordinary capital loss is while capital losses may only be deducted against capital gains, an ABIL may be deducted against all sources of income, including employment income. In order for a loss on debt or equity to qualify as an ABIL, it must meet certain complex and strict rules. When claiming an ABIL, make sure to keep all relevant information that may be required by CRA.

4. Tuition/Education Expenses

The CRA continues to ask for backup for any post-secondary tuition and/or education expenses claimed on a student's tax return. Ensure your children keep copies of all tuition slips, especially if the amounts are being transferred to you, the paying parent.

5. Carrying Charges

While expenses incurred for the purpose of earning investment income (such as interest expense on borrowed money) are typically tax-deductible, it's essential to keep the necessary supporting documentation and to ensure personal expenses are not being claimed.

This is particularly important when interest is being claimed on leveraged investing. If a line of credit (LOC) is used for investing, you must ensure that funds drawn from the LOC are being recorded in detail and not mixed with any personal expenses.

6. Foreign Tax Credits

If you earn foreign-source income, you must claim any foreign tax withheld as a credit on your Canadian personal tax return. This foreign tax credit can be used to offset any Canadian tax payable and will directly reduce Canadian tax dollar-for-dollar. That said, Deloitte reported that in 2004, the CRA has become much more active in questioning entitlement to foreign tax credits and reviewing taxpayer claims.

We can't emphasize enough the importance of keeping good records, especially foreign tax documents, bank or investment statements that may substantiate any foreign income earned and foreign taxes paid.

7. Child-Care Expenses

Many organizations provide receipts to parents for services that may not actually qualify for tax relief because their main purpose is not the provision of child care. Examples cited by Deloitte include athletic coaching, music lessons and tutoring.

For expenses to be deductible, they "must relate to the overwhelming component of guardianship, protection and child care. Recreational activities were never intended to be included as such an expense by Parliament…" Perhaps the reason for the confusion among some taxpayers is that these organizations often print "for tax purposes" on their receipts, potentially misleading parents into thinking such fees are tax-deductible as child-care expenses.

8. Verification of Capital Gains and Losses

When you purchase non-traditional investments, such as income trusts or investments in foreign currencies, the calculation of your capital gains and losses can attract unwanted attention. Income trusts pose a unique problem because they often distribute a "return of capital" (ROC), which is tax-advantageous since it's not currently taxable but rather reduces your adjusted cost base (ACB). You need to keep a record of your ACB adjustments so the correct capital gain or loss can be reported when the income trust is ultimately sold.

The other item to watch for when calculating a capital gain or loss is investments denominated in foreign currencies. When these are sold, you must calculate not only your economic gain but also the foreign exchange component of any gain or loss. The foreign exchange gain or loss calculation should be done by comparing the foreign exchange rate on the date of purchase with the rate on the date of sale, as opposed to the average rate for the year.

9. Province of Residence

As the debate about interprovincial tax planning continues to grow, provincial residency is increasingly an item of scrutiny for the CRA. For example, if you live in a province with a high marginal tax rate, it would be very attractive to take advantage of a lower marginal tax rate in another province. This could be done by acquiring a recreational property in the province with the lower rate, or even by merely establishing a mailing address in the province. Under our tax law, Canadians must pay provincial tax on their worldwide income based on the taxpayer's residence in a particular province on December 31.

10. Mining and Oil & Gas Investments

There are specialized tax rules governing investments in resource properties. If you choose to invest in such flow-through shares and other resource-based limited partnerships, you may wish to seek professional help come tax time. The CRA often requests additional information on amounts reported on the return when flow-through amounts and tax credits are claimed.

Getting Advice

Reviewing your Tax Plans? We encourage you to talk to us. Speak to your Financial Advisor or contact investor services at 1 800 608 7707.

GP WEALTH MANAGEMENT
INDEPENDENT THINKING WORKING FOR YOU