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Report From Counsel

Insights and Developments in the Law **Spring 2013**

The Tax Implications of Residing and Doing Business in Canada

By Brianne M. Dobush, Esq.

As companies look to expand into new markets, it is important to evaluate the tax implications of such a move. This article addresses the tax implications of doing business in Canada, as well as general tax principles for those who establish residence in Canada.

In Canada, income tax is based on residence, not citizenship. Therefore, a U.S. citizen residing in Canada will be fixed in Canada on worldwide income, either directly received or imputed, and will also be subject to U.S. tax based on their citizenship. However, the taxpayer will get credit in the U.S. for Canadian tax paid. The taxpayer will also receive foreign tax credit in Canada against Canadian tax to the extent that the foreign tax is payable on any particular source of income.

Canadian provinces generally base their income tax on federal tax, with the exception of Quebec. Personal rates range from a 39% combined top rate in Alberta to 49.53% in Ontario for income over $500,000. The top income tax rates start at about $130,000 (CAD), with Ontario surtax starting at about $85,000, which is why the Ontario rates are so much higher than Alberta.

The deduction of interest against taxes is limited to the principal amount of debt used to gain or produce income. For example, interest on investment loans to acquire securities is deductible, yet personal credit card interest is not. The capital gain from the sale of your principal residence is exempt from tax, but there is no deduction for the payment of interest on your mortgage.

With respect to estate planning, Canada does not have any federal or provincial estate tax. However, upon your death, you are deemed to have disposed of all of your assets at fair market value, so this opens up potential for capital gains tax. Therefore, most Canadian estate planning is geared towards dealing with and managing this capital gains liability. Trusts pay tax at a flat rate equal to the highest marginal rate in the province of residence. The solution is to allocate, although not necessarily distribute, income to beneficiaries who pay tax at their marginal rates.

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Independent Contractor Amnesty Program—Businesses Beware

By Jenifer M. Pinkham, Esq.

At the end of 2012, several employers contacted us asking whether they should reclassify their independent contractors as employees at the start of the new year. In several cases, the conversation was started because questions were raised by their accountants regarding whether or not the workers were misclassified. Each misclassification situation must be addressed on a case-by-case basis but several clients had questions relative to the Internal Revenue Service ("IRS") Amnesty Program.

The IRS recently announced an expansion of its Independent Contractor ("IC") Amnesty program also known as the Voluntary Classification Settlement Program ("VCSP") which it first started in September of 2011. Through this program the IRS permits taxpayers to voluntarily reclassify ICs as employees for federal employment tax purposes. Employers in the program generally pay just over 1% of the wages paid to the reclassified workers for the past year. There are no penalties and no interest, and employers will not be audited on payroll taxes related to these workers for prior years.

The expansion of the VCSP allows more employers to take advantage of the program, even those under IRS audit, those who failed to issue 1099s previously and also changes the statute of limitations or look back period. Employers under IRS audit now qualify as long as the audit is not specifically over employment taxes. Previously under the VCSP employers were barred if

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Arbitration Agreements Can Go Too Far

Strong public policies support the appropriate use of arbitration over litigation in settling legal disputes and, in fact, such policies underlie the Federal Arbitration Act. That said, an agreement to arbitrate disputes is subject to well-established principles rooted in the law of contracts. This means, among other things, that courts will step in and declare void an ostensible agreement to arbitrate if its effects are too heavily weighted in one party's favor. Two recent examples of this overreaching by the more powerful party illustrate the point.

In the first case, a former employee sued his former employer under the Fair Labor Standards Act for overtime wages. A federal appellate court prevented the employer from enforcing an arbitration agreement that was in the company's employee handbook. The fatal flaw in the arbitration provision was that rather than being a legitimate contract, the bargain was "illusory," a legal term meaning that one party, the employer, could effectively avoid its promise to arbitrate by amending the provision or even terminating it altogether.

Although the employer was required to provide an official written notice of any changes to the handbook, a change-in-terms clause gave the employer the "right to revise, delete, and add to the employee handbook" with retroactive effect. There was no savings clause excepting pending disputes from any changes made by the employer.

In the second case, the lopsided bargain that led a court to declare an arbitration agreement unenforceable was more a matter of dollars and cents. A couple purchased a home, contingent upon a satisfactory home inspection. They engaged the services of a home inspection company, which had an arbitration clause in its standard contract. The couple signed the contract, but its most objectionable parts were tucked away in the contract, either in fine print, or hidden among other clauses, or both.

The contract's provisions relating to arbitration were so one-sided in favor of the home inspection company that it effectively "exculpated" the company from liability in a way that violated public policy. In particular, the contract limited the clients' recovery from the inspector for a negligent inspection to the $285 contract fee; it also required binding arbitration of any dispute, even requiring the party seeking arbitration to pay, among other costs, an initial arbitration fee of $1,350, plus $450 per day after the first day of a hearing.

In short, clients could well end up paying out in fees and costs many times the maximum amount they could recover from the company. Also influencing the court's decision were the facts that home inspection services are generally thought suitable for public regulation and that the services provided by home inspectors are a matter of practical necessity for their clients and are crucial to the clients' decision to purchase a home.

To top it off, the court noted that the wife, who had been primarily responsible for the house purchase, had only a high school diploma and no expertise or experience in home construction and that the couple had never purchased a home and were entirely at the mercy of the inspector, without any means of protection if the inspector performed a careless inspection.

Financial Fraud Against the Elderly

It is a sad and sobering reality that scam artists intent on committing financial fraud or the outright stealing of money, property, or valuable information prey upon vulnerable senior citizens. The threats can take many forms, but the elderly and those watching out for them can have some measure of protection by taking a few basic precautions.

- Do your homework when selecting a professional advisor, even if the advisor comes highly recommended by a friend or family member. This means confirming that the person is registered or licensed and has not left a trail of mistreatment of other clients.
- Powers of attorney (POA) are helpful, maybe even essential, as age takes its toll on an individual's capacity to handle financial matters. But the potential for misuse of a POA is great, since the appointed person generally has free rein to do whatever the elderly person could do on his or her own. The selected person must be trustworthy, and it is a good idea to have an attorney review the POA document.
- The array of account numbers, Social Security numbers, pins, passwords, and other such sensitive information that most of us accumulate over time can serve as a thief's key for raiding your savings and investments. Guard this information carefully.
- It may be an after-the-fact measure, but check your credit card and bank account statements carefully for any unauthorized or suspicious transactions. If you see one, contact the financial institution right away.
- Reverse mortgages allow homeowners who are at least 62 years old to borrow money from the equity in their homes. This device has its place under the right set of circumstances, but a reverse mortgage can also become a device for scam artists. Be wary of deceptive, too-good-to-be-true offers and high-pressure tactics.

Independent Contractor

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they failed to file Forms 1099 for the workers they want to reclassify. However, until June 30, 2013, the IRS is waiving this requirement. Employers applying for the temporary relief for those who failed to file Forms 1099 pay a slightly higher amount than other participants plus some penalties. In addition, they must file any delinquent Forms 1099 for the workers they are seeking to reclassify. In addition, the IRS has reduced the special six-year statute of limitations to a normal three year statute.

To be eligible for the VCSP, an employer must:

- Currently be treating the workers as independent contractors;
- Consistently have treated them as such in the past, including filing Forms 1099;
- Not currently be under IRS audit on payroll tax issues;
- Not be under audit by the Department of Labor or state agencies for the classification of these workers; and

Not be contesting the classification of the workers in court.

Although the VCSP appears to be an attractive form of "amnesty," it has attracted only 1,000 businesses since its inception a few years ago. Enrollment in the voluntary program has been relatively scant, as companies recognize that this form of "amnesty" may be an invitation to state and federal workplace agencies and plaintiffs' class action lawyers to treat the reclassification as an admission of past wrongdoing.

Beware of this program for the following reasons: first, it does not provide any form of reduced penalties or interest with respect to the array of other federal and state laws that are implicated by reclassification, including state tax, unemployment, and workers' compensation as well as the federal wage and hour laws; and second, although the program evidently contains a provision that there is no admission that the taxpayer misclassified its workers as ICs, the likely presumption by the workers themselves, their lawyers (if any), and other federal and state agencies that may become involved is that the company would not have entered the program if it had been classifying its ICs correctly.

Massachusetts has one of the most employee-friendly independent contractor laws in the country. The Massachusetts law creates a heavy presumption of employee status and makes it very difficult to establish independent contractor status. Many Massachusetts employers have struggled with its application, a task made more difficult by the state's aggressive enforcement. Recently, the Massachusetts Joint Enforcement Task Force on the Underground Economy and Employee Misclassification announced "the commissioning of a research study to show the current depth and scope of employee misclassification and the underground economy in Massachusetts." The study is expected to be completed in 2013 and may be result in more onerous enforcement.

In 2008, Massachusetts Governor Deval Patrick signed Executive Order #499 establishing the Task Force to address employer fraud and worker misclassification. The Task Force's "guiding principles" were and are agency cooperation, the sharing of information, and the efficient use of resources to target violations and to educate the public. Massachusetts has sent a clear message: it is prepared to eradicate the misclassification of employees as independent contractors in the state. The increased communication and cooperation among the state agency "stakeholders" in rooting out misclassification likely will increase audits and enforcement action focused on independent contractors.

Employees misclassified as ICs under current laws can be costly for businesses, regardless of whether the employees have been mistakenly or intentionally misclassified. For some businesses, particularly those highly reliant on ICs, the potential costs of misclassification can be extremely high. Risks include liability for unpaid federal, state and local income tax withholdings and Social Security and Medicare contributions, unpaid workers' compensation and unemployment insurance premiums, and even unpaid work-related expenses and overtime compensation. Any one of these types of liabilities (plus interest and penalties for non-compliance) can be potentially devastating for businesses that make substantial use of ICs.

Massachusetts employers should consider taking steps to evaluate, identify and correct any misclassification issues. For reasons discussed above, businesses interested in reclassification should consider doing so voluntarily without entering the VCSP. Implementation also requires businesses to consider whether voluntary reclassification requires a different manner of compliance with relevant federal and state tax, employee benefits, and labor laws. If you have any questions about whether a worker is misclassified or how to voluntarily re-classify your workers, please do not hesitate to contact Jenifer M. Pinkham at 781-848-5028 or *jpinkham@sabusinesslaw.com*.

Employers Combat FMLA Abuse

The federal Family and Medical Leave Act (FMLA) gives eligible employees the right to up to 12 weeks of leave per year, which may be taken intermittently for certain specified reasons, including the care of designated family members with serious health conditions.

The FMLA also prohibits an employer from interfering with, restraining, or denying the exercise of or the attempt to exercise any right given under the FMLA. One of the bases upon which an employer can defeat an FMLA "interference" claim is a showing by the employer that an employee did not, in fact, take leave for a purpose authorized under the FMLA. Naturally, the availability of this defense has prompted some employers to undertake investigations of (some might say "spying on") employees suspected of abusing the rights afforded by the FMLA.

At least two federal courts of appeals have effectively allowed at least some degree of employee surveillance by holding that in order to defeat an FMLA interference claim based on an employee's asserted right to reinstatement, an employer need only show that it refused to reinstate the employee based on an "honest suspicion" that the employee was abusing his or her leave. Sometimes the basis for such a suspicion is produced by detective work of the kind engaged in by private investigators.

In one such case, the employer had an honest suspicion that an employee had misused his FMLA leave and, therefore, the employer's decision to terminate the employee did not interfere with the employee's right to reinstatement. The employer suspected that based upon the employee's prior absenteeism, the employee was misusing his FMLA leave, so the employer hired a private investigator to observe the employee on a day for which he had requested FMLA leave to care for his mother. Video surveillance revealed that the employee did not appear to leave his house that day.

When the employer questioned him, the employee could not recall what he had done on that day, but he asserted that he had not misused his FMLA leave. Although the employee later provided supportive documentation from his mother's nursing home and doctor's office, the paperwork did not clear the air but, rather, only raised further questions for the employer, as the documents were facially inconsistent and conflicted with the employer's internal paperwork.

In a second case, an employer was found to have had an honest belief that an employee had committed disability fraud in taking FMLA leave and, therefore, his termination for such fraud was found not to have been a pretext for FMLA retaliation.

It was not disputed that the employee suffered from a herniated disc and sciatica. However, although the employee had been approved for disability leave based upon his having reported excruciating pain and an inability to stand for more than 30 minutes, coworkers saw him at an Oktoberfest festival a few days later without any indication that his movements were painful or restricted. In fact, he was also able to walk 10 blocks and remain at the crowded festival for 90 minutes.

The employer's investigation included interviews with the coworkers, and the employee was permitted to submit documentation and other evidence in his defense. Still, when the dust settled, the court ruled that the employer had acted within its rights in terminating the employee. Importantly, the decisive question that sealed the employee's fate was not whether he had actually committed fraud, but whether his employer reasonably and honestly believed that he had.

Doing Business in Canada

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All of the provinces, except for Alberta, impose some form of sales, use or consumption tax. In most provinces, the rate is calculated by combining the federal rate (5%) with the provincial rate, resulting in the Harmonized Sales Tax (HST). The tax is levied on all goods and services, with limited exceptions for most groceries, medical services, and financial services, to name a few. The HST is imposed on the ultimate consumer, as businesses recover the HST that they pay on their inputs, resulting in no net tax cost to the business.

Canadian businesses are afforded a lower tax rate for dividend income than for other sources of income to reflect the corporate tax paid (which is similar to the U.S. concept of "integration"). The general corporate tax rate is calculated by combining the federal rate (15%) with the provincial rate. However, a Canadian controlled private corporation (CCPC) pays a lower corporate tax rate on the first $500,000 of income. CCPC status requires that control not be held by a non-resident or a public corporation. Therefore, a U.S. citizen residing in Canada could own and control a CCPC.

If you are considering relocating or expanding your business to Canada, we can help advise you on the important tax considerations of making such a move. We can also put you in contact with a Canadian tax attorney who can help ease your transition.