

Tax Reporting Obligations For Direct Sellers: What Needs to be Done and When?

With 2003 just concluding and new opportunities arising in 2004, now may be a good time for everyone to consider what tax filing obligations they may have in respect of their Canadian operations. This article provides a brief overview of those requirements.

T2 Tax Returns for All Corporations Carrying on Business in Canada

Corporate entities that are residents of Canada or who carry on business in Canada¹ are required pursuant to section 150(1) of the *Income Tax Act* (the "ITA") to file a Form T2 Corporation Income Tax Return within 6 months after their year-end.

These filing requirements would also apply to non-resident direct sellers that carry on business in Canada, even where their liability for Canadian income tax is eliminated by an Income Tax Treaty such as the Canada-U.S Income Tax Convention. To the extent a non-resident is effectively relieved from Canadian income tax (for example, if they qualify for Treaty relief and are not carrying on business through a permanent establishment), then they would also file Schedule 91: Information Concerning Claims for Treaty-Based Exemptions.

Possible Penalties For Non-Filing

Persons who fail to file an income tax return when required to do so, are subject to a late filing penalty which is unrelated to the actual amount of income taxes payable. Current penalties are a minimum of \$25 per day (minimum total penalty of \$100) and a maximum penalty of \$2,500 per year.

T4 Reporting For Canadian Employees

Canadian employers are required to deduct and remit certain amounts from wages and salaries paid to employees and are also subject to certain payroll taxes including employment insurance, CPP and income tax source withholdings. Besides having to remit all amounts withheld on a

¹ Pursuant to an extended meaning of "carrying on business" provided in section 253 of the ITA, non-resident corporations will be viewed as carrying on business in Canada, and potentially subject to tax under the ITA, if they solicit orders or offer anything for sale in Canada through an agent or servant, whether the contract or transaction is completed inside or outside Canada.

regular basis, employers are also required to issue T4 slips to their employees and file T4A-Summary forms with the tax authorities before February 28th.

T4A Reporting for ISCs who provide Services

Under the ITA, every person who pays an independent contractor (i.e., non-employees) for services is required to issue Form T4A's. The T4A reporting requirements are mandatory for each person who has received payments of more than \$500 in the calendar year, with the deadline for completing and filing T4A's being February 28th.

As most ISCs in the direct selling industry are not receiving payments for services (rather, the ISCs are considered to earn a profit based on the purchase and sale of products by the ISC and their downline), T4A reporting is generally not required in the direct selling industry where the ISCs are in fact distributors and not commissioned agents or sales representatives.

T4A-NR Reporting for Non-Residents

As further explained in our April 2003 Tax Corner article² Regulation 105 of the ITA applies to any payment made "*in respect of*" services rendered in Canada, and requires the payor to withhold 15% of all such payments. To the extent a direct seller makes any such payments, such withholdings are required to be remitted on a monthly basis with Form NR75- Non-Resident Remitter Registration Form. Furthermore, the direct selling company making the payment to the non-resident and withholding 15% of such amounts is required to file Form T4A-NR prior to February 28th.

Transfer Pricing Documentation

Pursuant to section 247 of the ITA, persons who acquire goods or services from a non-resident person with whom they are not dealing at arm's length (e.g. a Canadian direct selling company acquiring goods from its non-resident parent company), are required to base their prices on what arm's length persons would pay for the goods and services.

Although there is no obligation to have supporting documents which back up the reasonableness of the prices paid, in situations where the prices paid are overstated by more than 10% (or

² See *Cross Border Sponsoring and Possible Regulation 105 Considerations* (April 2003).

\$500,000), an additional 10% penalty may be levied if reasonable efforts were not made to determine an arm's length price. In order to establish that reasonable efforts were made, subsection 247(4) of the ITA generally requires the Canadian entity to have in its possession, and prior to its filing due date for its Corporation Income Tax Return, detailed documentation providing a complete, accurate and material description of the transactions including the functions performed and the risks assumed by each party in respect of the transactions, the terms and conditions of the transactions and the methods, assumptions and strategies used in determining the arm's length prices paid.

Provincial Tax Returns

In addition to the federal Corporation Income Tax Return, Canadian direct selling businesses may also have provincial tax return obligations. For example, section 75 of the Ontario *Corporations Tax Act* generally requires "every corporation" unless specifically exempted, to file an annual corporate tax return (Form CT23). Notwithstanding the broad filing requirements, corporations are only penalized for not filing the return if they are required to pay Ontario corporate tax – which generally requires the business to carry on business in Ontario through a permanent establishment in Ontario.

To the extent a direct seller is required to file Form CT23 in Ontario, the deadline for filing the forms is within 6 months following the company's year-end.

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