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Tax Alert – Canada

Finance releases proposed measures: avoidance of tax debts and audit authorities

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 4 February 2022, the Department of Finance (Finance) released draft legislation to amend the *Income Tax Act* (ITA) and the *Excise Tax Act* to reflect certain measures announced in the Canada 2021 federal budget, although some significant measures, such as changes to the Canadian transfer pricing regime and modernization of the general anti-avoidance rule, were not addressed. Interested parties are invited to provide comments on the proposed amendments by various dates. For further details, refer to [EY Tax Alert 2022 Issue No. 3](#).

The following tax alert explains income tax proposals included in the draft legislation concerning the avoidance of tax debts and audit authorities, in further detail.

Avoidance of tax debts

Section 160 of the ITA states that the Canada Revenue Agency (CRA) can assess a person (the transferee) for some or all of the tax debt of another person (the transferor) when the following four criteria exist:

1. The transferor transferred property to the transferee;
2. At the time of the transfer of property, the transferor was liable to pay taxes;

3. At the time of the transfer of property, the transferee was either (i) a spouse or common-law partner of the transferor (or has since become the spouse or common-law partner of the transferor), (ii) under 18 years old or (iii) not dealing at arm's length with the transferor; and
4. The transferee paid the transferor less than fair market value for the transferred property.

When these four criteria are satisfied, the transferee is liable to pay the lesser of (1) the transferor's tax debt at the time of the transfer and (2) the value of the property the transferee received from the transferor less the value of any consideration the transferee paid to the transferor for the property at the time of the transfer.

Section 160 of the ITA is amended following recent Federal Court of Appeal (FCA) and Tax Court decisions in *Eyeball Networks Inc. v. Canada* and *Damis Properties Inc. v. The Queen*, respectively, by adding subsection (5), which according to the explanatory notes "introduces new anti-avoidance rules to address abusive planning which seeks to circumvent the application of section 160".

- ▶ Paragraph 160(5)(a) addresses planning that seeks to avoid the application of section 160 through transactions designed to avoid a transfer of property between non-arm's length persons. It deems the transferor and the transferee to not be dealing at arm's length with each other if: (i) at any time during the period beginning immediately prior to the transaction or series of transactions and ending immediately after the transaction or series of transactions, the transferor and transferee do not deal at arm's length, and (ii) it is reasonable to conclude that one of the purposes of undertaking or arranging the transaction or series of transactions is to avoid joint liability of the transferee and transferor.
- ▶ Paragraph 160(5)(b) addresses planning that seeks to avoid the application of section 160 by avoiding the requirement that the transferor have a tax debt owing in respect of the year of the transfer or a preceding year. It deems a tax debt to arise in the taxation year in which the property was transferred if it is reasonable to conclude that one of the purposes for the transfer of property is to avoid the payment of a future tax debt by the transferor or transferee.
- ▶ Paragraph 160(5)(c) changes the calculation of the insufficiency of consideration used in calculating the transferee's maximum liability under section 160, in order to address planning that seeks to avoid the application of section 160 through transactions designed to minimize the fair market value of the transferred property. Previously, the insufficiency of the consideration was tested at the time when the transferee received the transferred property. Per the proposed subsection 160(5)(c), the fair market value of the consideration will be the lowest amount at any time in the period starting immediately before the transaction or series of transactions and ending immediately after the transaction or series, and where the consideration itself is cancelled or extinguished, there would be no consideration.

Further, the new section 160.01 of the ITA includes a third-party civil penalty regime for planning activity related to circumventing the application of section 160. This provision uses language similar to the existing third-party civil penalties in section 163.2, particularly the requirement of “culpable conduct” on the part of the third party. The penalty would be the lesser of (1) the total of \$100,000 plus the planner’s fees; and (2) 50% of the tax that is attempted to be avoided through the planning.

Audit authorities

Section 231.1 of the ITA provides the CRA with broad powers to examine records of taxpayers that may be relevant for audit and for the administration or enforcement of the legislation. The provision authorizes an auditor to enter a taxpayer’s business premises to “inspect, audit or examine” the books and records of a taxpayer, and in that context to require the “owner or manager of the property or business and any other person on the premises” to give the auditor “reasonable assistance” and answer “proper questions relating to the administration and enforcement” of the ITA. A separate provision, section 231.2, gives auditors the power to compel taxpayers as well as third parties to provide documents and answer certain questions in writing. If a taxpayer fails to provide the required information, the CRA may seek a compliance order from the Federal Court pursuant to section 231.7(1).

Due to a recent FCA decision, where the CRA was unsuccessful in having the courts support its use of section 231.1 to require functional interviews of a number of the taxpayer’s employees in the context of a transfer pricing audit, the government introduced draft legislation modernizing and expanding the CRA’s audit powers as follows:

- ▶ Expanding the category of persons required to provide all reasonable assistance to the CRA to include the “taxpayer or any other person”, whereas current legislation refers to the “owner or manager” of the business or a person who is on the property or business premises where the auditor conducts an examination of business records; and
- ▶ Compelling attendance of this broader category of persons at a place designated by the auditor – not just on business premises – or “by video-conference or by another form of electronic communication” to answer questions orally, or in writing now “in any form specified” by the auditor.

Learn more

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