Tax for the Owner-Manager

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New Planning Penalty for Avoidance of Tax Debts

The recent August 9, 2022 legislative proposals (now found in sections 38 and 39 of Bill C-32, which received royal assent on December 15, 2022) contain consequential amendments to section 160 of the ITA, including a new penalty provision ("the planning penalty") in subsection 160.01(2) in respect of section 160 avoidance planning.

Section 160 is a legislative scheme that provides rules regarding the joint and several, or solidary, liability of a taxpayer for the tax liability of another person not dealing with the taxpayer at arm's length when that other person transfers property to the taxpayer for consideration that is less than the property's FMV. These amendments appear to be a response to several court decisions in which taxpayers defeated attempts to apply section 160 (see, for example, *Eyeball Networks Inc. v. Canada*, 2021 FCA 17; and *Damis Properties Inc. v. The Queen*, 2021 TCC 44).

The New Subsection 160(5) Anti-Avoidance Rules

The planning penalty was introduced in conjunction with other consequential amendments to section 160 in subsection 160(5). Subsection 160(5) introduces new anti-avoidance rules, which are outlined below:

1) Paragraph (a) is a deeming rule designed to defeat planning that attempts to circumvent the application of section 160 by avoiding the requirement that property be transferred by parties that do not deal at arm's length.
2) Paragraph (b) introduces a rule designed to defeat planning that attempts to circumvent the application of section 160 by avoiding the requirement that the transferee have an existing tax debt owing in or in respect of the taxation year in which the property is transferred, or any preceding taxation year.
3) Paragraph (c) is a rule designed to ensure that when the FMV consideration given by the transferee is being determined, the period examined includes both the point of transfer and the period encompassing the series of transactions.

The Planning Penalty: Overview

The planning penalty in subsection 160.01(2) works in conjunction with these anti-avoidance rules and applies to "every person that engages in, participates in, assents to or acquiesces in planning activity that they know is section 160 avoidance planning, or would reasonably be expected to know is section 160 avoidance planning, but for circumstances amounting to gross negligence."

Relevant Definitions

In order to determine whether the planning penalty applies, reference must be made to several other complex definitions in subsection 160.01(1). The term "planning activity" takes its meaning from subsection 163.2(1) and includes a very broad variety of activities related to organizing, participating in, or arranging the planning.

Section 160 avoidance planning by a person means planning activity in respect of a transaction or series of transactions

- that is, or is part of, a section 160 avoidance transaction, and
- where one of the purposes of the transaction or series of transactions is to (1) reduce a transferee's joint and several, or solidary, liability for tax owing under the ITA by the transferor (or that would be owing by the transferor if not for a tax attribute transaction), or (2) reduce the person's or another person's ability to pay any amount owing, or that may become owing, under the ITA by that person.

A "section 160 avoidance transaction" is also defined; it is, essentially, planning to which one of the three new anti-avoidance rules in subsection 160(5) would apply.

A "tax attribute transaction" is also defined; it can be summarized as a transaction or series of transactions in which a tax attribute—of a person that dealt at arm's length with a transferor or transferee immediately before the transaction or series of transactions—is used, directly or indirectly, to provide a tax benefit for the transferor or transferee (as "tax benefit" is defined in subsection 163.2(1): specifically, a reduction, avoidance, or deferral of tax or other amount payable under the ITA or an increase in a refund of tax or other amount under the ITA).

The term "tax attribute" is also defined; the drafting of the definition is very broad and includes most commonly understood forms of tax attributes, such as capital and non-capital losses and PUC.

Amount of the Planning Penalty

The amount of the planning penalty can be summarized as the lesser of

- 50 percent of the joint and several, or solidary, liability payable under the ITA (ignoring subsection 160.01(2)) that was sought to be avoided through the planning; and
- the total of $100,000 and the person's gross entitlements ("gross entitlements" is a defined term drafted to broadly capture amounts, including contingent amounts, to which a person, or another person not dealing at arm's length with that person, becomes entitled in connection with the planning activity) at the time at which the notice of assessment of the penalty is sent to the person in respect of the planning.

However, subsection 160.01(2) provides a safe harbour to persons who provide only clerical services or secretarial services with respect to the planning.

The Planning Penalty in Broad Strokes

The planning penalty and the related anti-avoidance rules are a complex set of interweaving definitions encompassing a number of complex concepts that are all drafted extremely broadly. There are several key conclusions to draw from the legislation.

First, subsection 160(5) is deemed to have come into force on April 19, 2021 (the day that the 2021 federal budget was released). Section 160.01 is deemed to apply in respect of a transaction or a series of transactions that occurs, all or in part, after April 18, 2021. The 2021 federal budget did not provide draft legislation regarding these provisions. That draft legislation was first released by the Department of Finance for public comment on February 4, 2022 and was released again on August 9, 2022, with an invitation to provide comments and feedback. In our view, it is unreasonable for the government to have provisions, particularly penalty provisions, apply retroactively to a time when taxpayers did not know the terms of the legislation.

Second, this new penalty regime essentially targets planning that (1) attracts the anti-avoidance rules in subsection 160(5), (2) uses tax attributes to shelter a transferor or a transferee from section 160 liability, and (3) affects the ability of a transferee to pay a transferred liability. Because the rules in subsection 160(5) are extremely broad and target some of the key defences to a section 160 assessment (namely, the presence of an arm's-length transferee, the timing involved in determining the existence of a tax debt when property is transferred, and the presence of adequate consideration), extreme care is needed when any planning is being considered that could have the effect of stymying a section 160 assessment by using any of those key concepts or by using tax attributes to shelter a transferred liability.

Third, although there is a defence available to a planner (namely, that knowledge that the planner is participating in such planning is required), this defence is severely limited in that a person, notwithstanding a lack of explicit knowledge, can still be subject to the penalty if he or she could reasonably be expected to know—but for circumstances amounting to gross negligence—that the provision applies.

Fourth, the definition of "planning activity" is not exhaustive in that it uses the word "includes" and could, therefore, include activities that do not fall within the specific words of the provision and would not be known or knowable by a person. This raises the issue of whether a person can be assessed a penalty for an "activity" that the person would not know is a planning activity.

Fifth, the amount of the penalty can be very large, even though it is essentially capped at the sum of $100,000 plus the amounts received in respect of the planning activity by the relevant person.

In sum, this new planning penalty appears to provide a very onerous penalty of very broad application that could apply to an extremely broad range of taxpayers who may not have explicit knowledge that they have become subject to the penalty provision.

In light of the decision in *Guindon v. Canada* (2015 SCC 41), the prospect of the provision being deemed criminal and, therefore, subject to constitutional protections seems unlikely. One notes, however, that because this provision captures the giving of advice, with no carve-out for advice delivered by a solicitor, certain constitutional questions arise about its application to advisers who are lawyers.

Uncertainties aside, advisers should carefully examine any planning that could trigger this provision. Also, given that the defences hinge on questions of knowledge and intent, an adviser who believes that the planning he or she undertakes is not subject to this rule may be well advised to document the reasoning behind this conclusion contemporaneously with the planning.

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