Canadian Tax & Legal Alert

Budget proposes significantly enhanced audit and collection powers

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Budget 2021 proposes to extend and refine many previously announced federal measures to provide temporary relief for businesses and individuals from the economic effects of COVID-19. As the federal deficit continues to increase to unprecedented levels, driven in part by the provision of these public benefits, there is a corresponding need to identify and collect taxes owing as efficiently as possible.

To this end, the Minister of Finance (Minister) has announced several proposed amendments to the Income Tax Act (Canada) (Act) and other fiscal legislation that would enhance the powers of the Canada Revenue Agency (CRA) to audit taxpayers and ultimately improve the rate of recovery for tax debts. Many of the proposed amendments respond to perceived gaps in the legislation, highlighted in recent court decisions, or seek to align Canada's tax reporting with more exacting norms in other countries.

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The overall effect of these amendments could result in a significant shift in the landscape of tax administration and enforcement in Canada. Certain of the proposed new measures would seem to "outsource" the CRA's current task of identifying and investigating audit matters to taxpayers themselves. Under the proposed new rules, taxpayers may find themselves compelled to "self-audit", at their own time and expense, and to proactively identify transactions and filing positions the CRA might find objectionable.

This bulletin discusses key announcements and offers some context for, and commentary on, the proposed changes. It remains to be seen whether these amendments will be enacted as proposed, particularly after the applicable consultation period for the mandatory disclosure rules.[1]

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Executive summary of administration and enforcement measures in Budget 2021

In brief, Budget 2021 proposes changes to the administration and enforcement regime in the Act that would:

1. broaden the existing definition of "reportable transactions" and require reporting by taxpayers and promoters/advisors within 45 days from the date legal rights arise;
2. add a new category of more specific "notifiable transactions" published by the CRA that taxpayers and promoters/advisors would be required to report within 45 days from the date legal rights arise;
3. require corporate taxpayers with at least $50 million in assets, and which report their financials in accordance with International Financial Reporting Standards (IFRS) (or similar standards), to disclose their uncertain tax treatments to the CRA on an ongoing basis.
4. impose financial penalties for failing to report a transaction covered by the mandatory disclosure requirements, on both taxpayers and their promoters/advisors;
5. suspend the commencement of the normal reassessment period in respect of an unreported transaction, until the information required to be reported is filed with the CRA;
6. broaden the third-party liability rule in section 160 of the Act to consider: taxpayer purpose, overall effect of transactions, and what a transferor would have known about a future tax liability if reasonable inquiries were made, and impose financial penalties on planners and promoters of tax debt avoidance schemes.

[1] Budget 2021 states that the Department of Finance will be consulting stakeholders on the proposals related to reportable transactions, notifiable transactions, and uncertain tax treatments, in addition to the penalties and suspension of the normal reassessment period related thereto.

I. Enhanced information requests

Section 231.1 and related provisions in Part XV of the Act confer powers on the CRA to audit and investigate the tax liability of any taxpayer. While these rules are necessarily broad due to Canada's tax system, which requires taxpayers to self-assess their tax liability at first instance, they are not unlimited.

For example, recent court decisions have held that, as currently drafted, these rules do not allow the CRA to compel oral answers to its audit questions.[2] The Federal Court of Appeal reasoned that if the results were otherwise, the CRA's audit powers under paragraph 231.1(1)(a) would be "significantly broader" than even the power to conduct a formal inquiry under section 231.4, which is subject to additional procedural safeguards.[3] Courts have also found that while the current rules require taxpayers to *respond* to the CRA's questions, they do not allow the CRA to mandate the *form* in which a response is provided.[4]

The draft rules tabled in Budget 2021 would broaden the CRA's audit powers considerably, such that the CRA may require taxpayers to answer questions "orally or in writing, in any form specified". These amendments could require taxpayers to make specific individuals, including directors, officers, or employees, available for interviews with CRA auditors upon request, effectively resulting in an "on-demand" examination for discovery without the safeguards inherent in the formal litigation process. The amendments would ostensibly also allow the CRA to compel taxpayers to create new documents (*e.g.*, organizational charts, timelines, etc.) to assist the auditor, which were previously not compellable as a matter of law.

It is presently unclear how these new CRA audit powers, if enacted, might be constrained so as not to impose unduly onerous compliance obligations and costs on taxpayers. Courts tasked with interpreting these rules may find renewed importance in the rules' existing qualification – *i.e.*, requiring taxpayers to answer only "proper questions", or recognize inherent limits based on reasonableness or proportionality to provide a check on the Minister's investigative powers.

II. Reportable transactions

Since 2011, the Act has required taxpayers to report certain avoidance transactions – known as "reportable transactions" – to the CRA. Currently, the requirements for a reportable transaction are that at least two of the following three "general hallmarks" of tax avoidance are present:

- a promoter or advisor receives a fee contingent on a tax benefit or the number of persons who receive advice, or participate in, tax avoidance;
- a promoter or advisor requires "confidential protection" in respect of the transaction; or
- the taxpayer or a person who entered into the transaction for the taxpayer's benefit, obtains "contractual protection" in respect of the transaction.

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[2] *Canada (National Revenue) v. Cameco Corporation*, 2017 FC 763, aff'd 2019 FCA 67 [*Cameco* appeal].
[3] *Cameco* appeal, *ibid.* at para 34.
[4] See, *e.g., Minister of National Revenue v. Amdocs Canadian Managed Services Inc.*, 2015 FC 1234.

Certain persons who facilitate, or benefit from, reportable transactions are required under the current rules to file an information return in prescribed form by June 30 of the calendar year *following* the calendar year in which the reportable transaction first arose.

To address perceived limited reporting under the current regime, Budget 2021 proposes to reduce the threshold for reportable transactions, such that only one of the above criteria would be sufficient. In addition, the reporting deadline for these transactions would be shortened to a mere 45 days following the *earlier* of: (i) the contractual obligation to enter into the avoidance transaction; and (ii) the actual entering into of the avoidance transaction.

The reporting requirement would also be extended to a broader category of persons, including promoters and advisors, and persons not dealing at arm's length with promoters and advisors, who are entitled to compensation with respect to the transaction. The only identified exception from this broader reporting requirement would be where the advice is subject to solicitor-client privilege.

These amendments seek to better implement international standards for identifying revenue risks and responding in a timely manner, as discussed in the report on Action 12 of the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) initiative. It remains to be seen whether these amendments, which would require broader reporting of transactions, by more persons, and on shorter timelines, would be accompanied by additional audit resources and increased timeliness in conducting audits on the CRA's part.

III. Notifiable transactions

In addition to the category of reportable transactions, the Minister has also proposed to introduce a new category of "notifiable transactions". The key difference between these categories is that unlike the "general hallmarks" of reportable transactions discussed above, the CRA would publish "specific hallmarks" of notifiable transactions. The published descriptions would "set out the fact patterns or outcomes that constitute that transaction in sufficient detail" to enable taxpayer reporting compliance, including examples in some instances.

An example of a notifiable transaction offered in Budget 2021 relates to the recent Tax Court decision in *Paletta v. The Queen*,[5] where the taxpayer engaged in "straddle-loss" transactions that the CRA found offensive, but which were reassessed outside of the applicable normal reassessment period. According to Budget 2021, the creation of the new category of notifiable transactions that are subject to reporting requirements would obviate the need for the CRA to undertake the "challenging and time consuming" task of establishing that the taxpayer made a misrepresentation attributable to neglect, carelessness or wilful default in order to overcome the statutory time limitation and issue a reassessment.

The obligation to report notifiable transactions to the CRA would follow the same 45-day timing as for reportable transactions and would also apply to promoters and advisors. Again, the Minister has sought to better align Canada's

[5] 2021 TCC 11.

mandatory disclosure requirements with those of tax treaty partners in the international community.

As with the enhanced reportable transactions regime, it is unclear if the CRA will be devoting additional resources to audit and reassess more quickly, or if the CRA will instead rely on the related consequences of non-compliance as a measure of protection, as discussed below.

The details of the notifiable transaction regime are unclear as of yet. However, these rules, if enacted as proposed, would undoubtedly shift significant responsibility to taxpayers to continually inform themselves of transactions that fall within this category, making compliance onerous and difficult. This is particularly concerning since the Ministers of Finance and National Revenue would jointly have the authority to publish not only transactions the CRA has found abusive, but also "transactions of interest", which could lead to a lengthy list of notifiable transactions. This list would not be subject to the oversight of Parliament as a whole and could therefore change frequently. In addition to the specific transactions published, notifiable transactions would also include "a transaction or series of transactions that is substantially similar to a notifiable transaction", which would add significant interpretive uncertainty to the current proposals.

IV. Uncertain tax treatments

A major proposed change would require taxpayers to proactively report "uncertain tax treatments" to the CRA, presumably under one or more new, standalone provisions of the Act.

Recent court decisions have clarified that taxpayers currently have limited protection from disclosing such positions under section 231.1 of the Act. The Federal Court of Appeal in *Canada (National Revenue) v. BP Canada Energy Company*,[6] held that taxpayers are not required to "self-audit" by providing uncertain tax positions to the CRA on an ongoing basis, *i.e.*, outside of an existing audit. Absent solicitor-client privilege, however, the effect of the decision on appeal was to confirm that the CRA may access tax accrual working papers that identify uncertain tax positions in the context of an audit.

Building on the appellate ruling in *BP Canada*, Budget 2021 would require certain corporate taxpayers to effectively provide an audit roadmap on a proactive and ongoing basis, even if they are not currently under audit for a particular transaction or taxation year.

As proposed, the new reporting requirement would apply to a corporate taxpayer that meets all of the following criteria:

- is a resident of Canada or a non-resident subject to Canadian taxation;
- has at least $50 million in assets at the end of the financial year (or the previous financial year) coinciding with the taxation year;
- has, or is related to another corporation that has, audited financial statements prepared in accordance with IFRS or other country-specific, generally accepted accounting principles for public corporations; and

[6] 2015 FC 714, rev'd 2017 FCA 61 [*BP Canada*].

- has expressed uncertainty in respect of Canadian income tax liability for the taxation year in its audited financial statements.

While details of the proposed reporting requirements are not yet available in the form of draft legislation, the Budget 2021 commentary refers to the following examples of information that would be required in respect of *each uncertain tax treatment*:

> […] prescribed information, such as the quantum of taxes at issue, a concise description of the relevant facts, the tax treatment taken (including the relevant sections of the Income Tax Act) and whether the uncertainty relates to a permanent or temporary difference in tax.

According to Budget 2021, these measures would better align Canada's tax system with those in the US, the UK and Australia, where such reporting is already required. Comments in Budget 2021 also refer to the relatively low administrative burden of providing this information, given that corporate taxpayers whose financial statements are prepared in accordance with the relevant reporting standards would have already gathered information about uncertain tax positions for which reserves are taken. While corporate taxpayers may take solace in a new tax compliance measure that is not particularly burdensome, this would likely be overshadowed by the significant shift in the Canadian tax landscape towards a new "self-audit" reality.

We would expect that Chartered Professional Accountants of Canada (CPA Canada) will wish to make submissions on behalf of the industry on these proposed measures during the consultation period.

V. Effects of non-compliance

Perhaps the most significant proposed changes to how the Act is administered and enforced are the consequences of non-compliance with mandatory disclosure rules, including the proposed (new) rules for reportable transactions, notifiable transactions, and uncertain tax treatments discussed above.

Budget 2021 would impose both significant financial penalties and procedural consequences for failing to file information with respect to reportable transactions and notifiable transactions, as required under the proposed new rules.

Financial penalties would apply differently to corporations with assets in excess of $50 million, other taxpayers, and promoters and advisors:

- corporations meeting the asset threshold would be subject to penalties of $2,000 per week to a maximum of the *greater* of $100,000 and 25% of the tax benefit;
- other taxpayers would be subject to penalties of $500 per week to a maximum of the *greater* of $25,000 and 25% of the tax benefit; and
- promoters and advisors (and compensated non-arm's length persons) would be subject to penalties equal to the *total* of 100% of the fees, $10,000, and $1,000 for each day the failure to report continues, with this last component being capped at $100,000.

Given the potentially broad categories of reportable transactions and notifiable transactions, these significant penalties appear designed to require taxpayers to "err" on the side of overreporting and therefore effectively self-auditing.

As a procedural consequence of non-reporting, the commencement of the normal reassessment period would be suspended until such time as the required information is reported. This change is potentially significant and wide-reaching, particularly if a taxpayer took the view that no reporting was required and, years later, a court decided otherwise. If this amendment is enacted as proposed, it would again incentivize taxpayers to overreport transactions or otherwise face the risk of an indefinite reassessment period.

Penalties for failure to report uncertain tax treatments would be $2,000 per week to a maximum of $100,000, *for each particular uncertain tax treatment*. These penalties would be imposed on all taxpayers regardless of their size or asset value, presumably since the requirement to disclose uncertain tax treatments is already restricted to corporate taxpayers that are required to adhere to more advanced financial reporting standards, and therefore would exclude most small corporations with limited assets.

VI. Collection of tax debts under section 160

Section 160 of the Act contains an anti-avoidance rule for tax collection purposes. This rule generally imposes tax liability on a person where:

- the person (the "transferee") receives property directly or indirectly, from another person (the "transferor");
- the transferor and the transferee do not deal at arm's length (or fall within another prescribed category); and
- at the time of the transfer, the transferor is liable to pay tax.

If these conditions are met, the transferee – who otherwise may not have participated in the activity that caused the transferor's tax liability – becomes jointly and severally liable for the transferor's tax liability to the extent that the fair market value of the consideration the transferee provided for the property was less than the fair market value of such property.

Recent court decisions have considered different scenarios where the CRA assessed persons under section 160 and relied, in the alternative, on the general anti-avoidance rule (GAAR) in section 245. In some of these cases, taxpayers have successfully argued that one or more of the conditions for the technical application of section 160 was not present. As a result, courts were asked to consider whether there was nevertheless a tax benefit that arose from abusive avoidance of section 160, such that the GAAR should apply. Mixed results from these decisions at the first instance and, in some cases, on appeal, have highlighted the difficulty in applying the GAAR to the specific anti-avoidance provision for collections in section 160.[7]

Budget 2021 seeks to supplement section 160 with additional anti-avoidance rules that would target transactions where the technical conditions to apply

[7] See, *e.g.*, *Canada v. 594710 British Columbia Ltd.*, 2018 FCA 166; *Eyeball Networks Inc. v. Canada*, 2021 FCA 17; *Damis Properties Inc. v. The Queen*, 2021 TCC 24.

section 160 are not met. While specific draft legislation is not yet available, the proposed measures would generally:

- target mismatches in timing;
- require consideration of the parties' intentions or purposes in entering into transactions;
- require consideration of what knowledge a transferor had, or would have had, if reasonable inquiries were made; and
- determine fair market values based on the overall result of a series of transactions, rather than at a discrete point in time.

These measures would also include financial penalties for "planners and promoters of tax debt avoidance schemes" consisting of the lesser of: (i) 50% of the tax that was attempted to be avoided, and (ii) $100,000 plus the promoter or planner's compensation for the scheme.

These proposed measures send a strong message to potential participants in, and planners and promoters of, certain categories of transactions. Given the breadth of the rules in section 160, it remains to be seen whether these proposed amendments, if enacted, will encourage the CRA to continue relying on this provision frequently, and if this reliance may subject an even greater number of *bona fide* transactions to audit and assessment.

For more information, or if you have any questions, please reach out to your Deloitte advisor or any of the individuals noted on this alert.

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