Aggressive tax proposals ("AT proposals") draft legislation released by the Department of Finance

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October 14, 2010

On August 27, 2010, the Department of Finance released the draft legislation for the AT proposals that were first announced in the Federal Budget of March 4, 2010 which our firm commented on in our March 5, 2010 blog. Various organizations such as the Society of Trust and Estate Practitioners ("STEP") and the Canadian Tax Foundation have also since commented on the AT proposals.

New proposed section 237.3 of the *Income Tax Act* ("Act") will deal with the AT proposals. I will try to summarize the material by answering a series of obvious questions below.

Who do the AT proposals apply to?

New section 237.3 provides a series of definitions including "advisor" and "promoter". The definitions are extremely broad and will generally capture any accountant, lawyer, financial planner, investment advisor, etc. who assists with or promotes a tax plan that provides tax benefits and receives fees (the definition of advisor also includes a person who provides "contractual protection" – another defined phrase that generally captures arrangements that protect the person who is entering into the arrangement). While the draft legislation is much more detailed than described herein, suffice it to say that the AT proposals apply to promoters, advisors and taxpayers who enter into transactions that are "reportable transactions" as described below.

What conditions need to exist for the AT proposals to apply?

For the AT proposals to apply, there must be a "reportable transaction" (a defined phrase in the draft legislation). Very generally, a reportable transaction is an avoidance transaction (defined pursuant to the general anti-avoidance rule ("GAAR") legislation in section 245 of the Act) where, at any time, any two of the following paragraphs apply:

a) An advisor or promoter has or had an entitlement to a fee that to any extent:

i. is based on the amount of a tax benefit;
ii. is contingent upon the obtaining of a tax benefit; or
iii. is attributable to the number of persons who participate in the transaction or have been provided access to advice or an opinion given by the advisor or promoter regarding the tax consequences from the transaction,

b) An advisor or promoter in respect of the avoidance transaction has or had confidential protection in respect of the avoidance transaction or series, or

c) The person, advisor or promoter has or had contractual protection in respect of the avoidance transaction or series.

Again, as stated earlier, the draft legislation is much more detailed than that written above and attention will need to be paid to the details. In addition, there are numerous defined phrases that will need to be considered such as a “fee” (which is very broadly defined and can capture essentially any consideration received by the advisor or promoter) and “confidential protection” which, generally, will capture a confidentially agreement whereby the details of the tax plan are not to be disclosed to anybody. The phrase “contractual protection” is also defined and very generally includes protection for the taxpayer to the extent that the tax plan is attacked by an appropriate authority.

If there is a reportable transaction, what happens?

New subsection 237.3(2) of the AT proposals require that, to the extent there is a reportable transaction, there must be a prescribed form disclosure in respect of such transaction and such disclosure must be filed with the CRA by:

a) Every person for whom a tax benefit results;

b) Every person who has entered into, for the benefit of the person in (a) above, an avoidance transaction that is a reportable transaction; and

c) Every advisor or promoter who is entitled to a fee.

When must such information returns be filed with the CRA to the extent that section 237.3 applies?

The draft legislation requires that if any person is required to file an information return in respect of a reportable transaction then it must be filed by June 30 of the calendar year following the calendar year in which the transaction first became a reportable transaction in respect of the person. However, if any person is required to file an information return in respect of a reportable transaction the filing by any such person of the information return with full and accurate disclosure in respect of the transaction is deemed to be made by each person to whom that requirement applies in respect to the transaction.

What happens if the information returns that are required to be filed are not filed?
If the information returns that are otherwise required to be filed are not filed, then the tax benefit that may otherwise be available to the taxpayer is denied. In addition, a person is liable to a penalty which is computed separately.

What are the penalties and who do they apply to?
The penalties apply to every person who fails to file an information return which is otherwise required to be filed. Overly simplified, the penalty amount that applies to the advisor or promoter will generally equal the fees that were received by such people. The taxpayer who entered into the transaction will generally be subject to a penalty equal to the amount of the fee that was paid to the advisor/promoter. In addition, all of the persons who are liable to a penalty in respect of the transactions are jointly and severally liable to pay such penalties (up to the amount of the penalty that they are otherwise liable for).

Are there any exceptions to the penalties?
Yes. Firstly, the draft legislation provides that a person is not liable to a penalty if the person has exercised the degree of care, diligence and skill to prevent the failure to file the prescribed information with the CRA that a reasonably prudent person would have exercised in comparable circumstances.

Secondly, a reportable transaction does not include a transaction or series of transactions that includes

the acquisition of a tax shelter for which prescribed information has already been filed with the CRA, or the issuance of a flow-through share for which prescribed information has been filed.

When do these new rules apply?

The new AT proposals apply in respect of avoidance transactions that are entered into after 2010 or that are part of a series of transactions that began before 2011 and is completed after 2010.

It is important to note that if the filing of an information return under section 237.3 would be required before July 1, 2011, the information return is deemed to be filed before that day if it is filed before 2012.

Is Canada cutting new ground here with these new proposals?

No. Other jurisdictions such as Quebec, the US, the UK and other countries have introduced similar legislation. Reasons that have been set forth by the various other countries and Quebec for introducing such rules are to assist tax administrators with early identification of transactions that may otherwise have not been easy to find for audit purposes. US rules, as an example, appear to be a lot more invasive than the Federal proposals but time will tell whether or not such rules are tinkered with to achieve the fiscal policy result that the Federal Government is intending to achieve.

Can you provide me with an example of how these new rules might apply?

Sure, consider the following:

1. An accountant, Mr. Apple, has a public practice firm.
2. Mr. Apple is approached by Mr. Orange to participate in a particular tax strategy that Mr. Orange's company has developed.
3. For every client that Mr. Apple refers, he will receive $5,000 for every instance that a client "acquires" the tax strategy.
4. Mr. Apple must sign a confidentiality agreement with Mr. Orange's company that he will not disclose the particular tax strategy to anyone other than clients of his that have signed the confidentiality agreement referred to below.
5. In addition, if any of Mr. Apple's clients participate in the strategy, they will need to sign a confidentiality agreement with Mr. Orange's company.
6. If any of Mr. Apple's clients participate in the tax strategy, the client would pay Mr. Orange's company a flat fee of $25,000.
7. Mr. Orange informs all of his clients that if the tax strategy is ever challenged by the CRA that Mr. Orange's company would pay for the costs associated with the tax dispute.
8. Mr. Apple has referred 100 clients to Mr. Orange and received $500,000 as a referral fee from Mr. Orange's company.
9. The CRA has audited the 100 clients and denied the tax benefit to the clients via reassessment.
10. All of the transactions and/or series referred to above ended in 2011.

Analysis

- Does new section 237.3 apply?
- If so, what are the reporting obligations?
- If the reporting obligations are not complied with, what are the consequences?

Does Section 237.3 Apply?

- Yes, new section 237.3 will apply since the transactions or series were entered into after 2010 or were part of a series of transactions that began before 2011 but are completed after 2010.
- Mr. Apple is likely an "advisor" since he has provided assistance or advice with respect to…planning…or implementing the transaction to any person. Mr. Orange's company is also likely an advisor.
- Mr. Apple and Mr. Orange's company are also likely "promoters" since they promote or sell the plan/scheme and make representations that a tax benefit could arise from the transaction or series. They also both accepted consideration in respect of the plan.
- The transactions entered into by the clients of Mr. Apple are likely reportable transaction(s) since:

a) The transactions are likely avoidance transactions and an advisor or promoter (Mr. Apple and Mr. Orange) have had an entitlement to a fee that is attributable to the number of persons who participate in the transaction(s) (clause 237.3(1)(a)(iii)(A) of the definition of "reportable transaction").

b) Mr. Apple and Mr. Orange's company had "confidential protection" in respect of the transactions (paragraph 237.3(1)(b) of the definition of "reportable transaction").

c) Mr. Apple's clients had "contractual protection" in respect of the transactions (subparagraph 237.3(1)(c)(i) of the definition of "reportable transaction").

- Since two of the three paragraphs are met (in this case all three paragraphs are met), the transactions are "reportable transactions".

Reporting Obligations

- Mr. Apple's clients must file prescribed information (paragraph 237.3(2)(a)).
- Mr. Apple and Mr. Orange's company must file prescribed information (paragraph 237.3(2)(c)).
- Mr. Apple's clients and Mr. Apple and Mr. Orange's company will satisfy reporting obligations if full and accurate disclosure is made by any person (not for the entire 100 clients though…each client must be considered separately) – (subsection 237.3(4)).
- The information return must be filed by June 30 of the calendar year following the calendar year in which the transaction first became a reportable transaction (subsection 237.3(5)).
- If information returns are not filed, subsection 245(2) will be deemed to apply to the reportable transactions resulting in denial of tax benefits for Mr. Apple's clients (paragraph 237.3(6)(a)).
- A person is liable to a penalty (paragraph 237.3(6)(b)).
- Penalties under subsection 237.3(8) must be calculated.
- Mr. Apple's penalty – $5,000 x 100 = $500,000 (limited to $500,000 because of subsection 237.3(10)).
- Mr. Orange's company penalty – $25,000 x 100 = $2,500,000 (paragraph 237.3(8)(a) and limited to this amount because of subsection 237.3(10)).
- Each of Mr. Apple's clients – $30,000 (the sum of the advisor and promoter fees).
- Joint and several liability – subsection 237.3(9).
- Note that each taxpayer client has joint and several liability that is not limited and therefore each client's possible penalty exposure is $60,000.

Can you comment on some of the implications of these rules?

Sure. The AT proposals will have wide sweeping changes to the practice of tax. Taxpayers and their advisors need to be well aware of these proposals and the potential penalties that they could become liable for if they do not pay careful attention to these new reporting rules. Here are some quick things to

think about:

Are the new rules going to harm solicitor-client privilege in some cases?

The answer to this question is very debatable. Some people that we have discussed this matter with believe strongly that the AT proposals strike at the very heart of the solicitor-client relationship. However, other practitioners point to certain Supreme Court of Canada case law which clearly states that you cannot legislate over solicitor-client privilege. Stay tuned….this matter will likely be hotly debated into the future.

What exactly does the phrase "…avoidance transactions that are entered into after 2010 or that are part of a series of transactions that began before 2011 and is completed after 2010…" mean?

For example, what if some proprietary transactions/strategies were entered into by a taxpayer in 2005 to increase the cost base of capital property (and such transactions are likely avoidance transactions) but the capital property is disposed of by the taxpayer in 2012? Will the tax advisor be required to file an information return in respect of transactions that were entered into in 2005? Good question…not sure what the answer is but certainly taxpayers and their advisors should consider this and come to an appropriate conclusion.

Overall, taxpayers and their advisors, especially accountants, lawyers, financial planners, etc. will need to carefully consider the promotion of a tax plan or strategy given the broadness of this draft legislation.