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DEFENCES TO TAX ASSESSMENTS ARISING FROM CONVEYANCES OF ASSETS TO RELATED PERSONS - PART 1

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm about defences which can be used to deal with assessments issued in respect of non-arm's length property transfers. Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.

A. INTRODUCTION

The provisions of subsection 160(1) of the Income Tax Act (the "Act"), impose *joint and several liability* for tax on certain transfers of property between persons who do not deal at arm's length with each other. Pursuant to this subsection, both the transferor and the transferee are jointly and severally liable for certain taxes for which the transferor would otherwise alone be liable. This joint liability occurs in situations where property is transferred in accordance with subparagraphs 160(1)(d) and 160(1)(e) of the Act to any non-arm's length persons. The modern test for the application of subsection 160(1) was established by the Federal Court of Appeal in *Livingston v. R, as follows:*

> "In light of the clear meaning of the words of subsection 160(1), the criteria to apply when considering subsection 160(1) are self-evident:
>
> (i) The transferor must be liable to pay tax under the Act at the time of transfer;
> (ii) There must be a transfer of property, either directly or indirectly, by means of a trust or by any other means whatever;
> (iii) The transferee must either be:
>   (a) The transferor's spouse or common-law partner at the time of transfer or a person who has since become the person's spouse or common-law partner;
>   (b) A person who was under 18 years of age at the time of transfer; or
>   (c) A person with whom the transferor was not dealing at arm's length.
> (iv) The fair market value of the property transferred must exceed the fair market value of the consideration given by the transferee."

B. VALUATION OF LIABILITY

Pursuant to subparagraph 160(1)(d) of the Act, the transferee and transferor are jointly and severally liable to pay the amount by which the transferor's tax liability has been increased as a result of the operation of the *attribution rules* in the following sections of the Act:

(i) Subsections 74.1(1) and 74.2(1) of the Act, which state that any income or taxable capital gains from property transferred or loaned to his spouse or common-law partner or person who has since become his spouse or common-law partner is income or a taxable capital gain of the transferor.

(ii) Subsection 74.1(2) of the Act, which provides that where a taxpayer has transferred or loaned property to a person who was under 18 years of age, the income from the property is deemed to be income of the transferor and not of the transferee, unless the transferee has before the end of the year attained the age of 18 years; and

(iii) Section 75.1 of the Act, which provides that where farming assets have been transferred to a child on a rollover basis under subsection 73(3) and the child disposes of those assets before reaching age 18, the taxable capital gains realized are deemed to be the taxable capital gains of the transferor.

Although the income or capital gain from such property will be received by the transferee under sections 74 to 75.1 of the Act the liability for the tax will be on the transferor. The purpose of the provisions in subparagraph 160(1)(d) of the Act is to enable the CRA to recover the amount of the tax liability from the actual recipient of the income *as well* as from the person liable under sections 74 to 75.1 of the Act.

Pursuant to subparagraph 160(1)(e) of the Act, in the case of any transfer to a non-arm's length persons specified in subsection 160(1) of the Act, the transferor and transferee are *jointly and severally* liable for the lesser of either (i) the income tax liability of the transferor at the date of the transfer or (ii) the value of the property the transferee received less any consideration paid by the transferee to the transferor. In essence, the transferee is only liable to the extent that their gift reduced the actual tax paid by the transferor.

This joint liability extends to liability for any source deductions which the transferor is liable to remit in that year, or a preceding year. It should be noted that similar provisions exist in the Excise Tax Act. Specifically subsection 325(1) of the Excise Tax Act, reiterates the provisions of subsection 160(1) of the Act.

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The purpose of subparagraph 160(1)(e) of the Act appears to be to prevent a person with a substantial income tax liability from defeating the claims of the Minister of National Revenue ("the Minister") by transferring his property to a spouse, an intended spouse, a person under 18 or any non-arm's length party at less than fair market value consideration.

The definition of non-arms length person includes situations in which one partner has already died. The court determined in *Kuchta v. R*. (2015 TCC 289) that the definition of “spouse” was clearly intended to apply to widows and widowers.

C. <u>ADDITIONAL ASSOCIATED PROVISIONS</u>

Subsection 160(1.1) of the Act further expands the reach of the Minister. This provision provides that where subsection 69(11) of the Act applies to deem a disposition of property to have occurred at fair market value, both the person disposing of the property and the person acquiring the property are jointly and severally liable for the payment of each other's tax liabilities arising under the Act as a result of that disposition. Essentially, each person's tax liability for any taxation year affected by the disposition is the excess of the amount of tax payable under the Act by that person for that year over the amount of tax that would have been payable by that person for that year had subsection 69(11) of the Act not applied to the disposition. Subsection 69(11) of the Act applies to a taxpayer's disposition of property at less than fair market value and as a part of *a series of transactions or events,* where it can reasonably be considered that one of the main purposes of the series is to obtain certain tax benefits available to another person in respect of a subsequent disposition of the property, typically the transferee of the property. However, note that subsection 69(11) of the Act only applies if arrangements for the subsequent disposition are made within 3 years after the original disposition by the taxpayer.

Pursuant to subsection 160(1.2) of the Act, a parent of a minor child is, in certain situations, *jointly and severally* liable for the tax payable on the child's split income under section 120.4 of the Act (which imposes a tax on minor child's split income including (i) taxable dividends received on certain shares of a corporation; and (ii) the child's share of income from a trust or partnership that is derived from the provision of property and services carried on by a person related to the child or by a corporation in which a person related to the child is a specified shareholder).

Pursuant to subsection 160(1.3) of the Act, if both spouses or common-law partners jointly elect to split pension income in accordance with section 60.03 of the Act,

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the pensioner and transferee are jointly and severally liable for the tax payable on the split income.

In regards to discharging joint liability, pursuant to subsection 160(3) of the Act, where a particular taxpayer is jointly and severally liable with another taxpayer under subsection 160(1) of the Act for the other taxpayer's liability under the Act, a payment by the particular taxpayer on account of his tax liability under subsection 160(1) or 160(1.1) of the Act, shall to the extent of the payment discharge the joint liability. However, if the other taxpayer makes a payment on account of his income tax liability, the payment is taken to first apply to any income tax liability of the other taxpayer other than the joint and several liability, and secondly to discharge the joint and several liability. The liability of the particular taxpayer will be reduced only to the extent that the total tax liability of the taxpayer is reduced below the joint and several liability.

Pursuant to subsection 160(4) of the Act, there is an exemption from joint and several liability under subsection 160(1) of the Act where the property is transferred to the taxpayer's spouse or common law partner (i) pursuant to a Court order or a written separation agreement and (ii) at a time when the taxpayer and his spouse or common-law partner were living separate and apart as a result of the *breakdown* of their marriage or common-law partnership. As result, in such limited circumstances the tax liability from the property transfer would fall solely on the transferor, excluding the transferee (i.e. the taxpayer's spouse's or common-law partner) from joint and several liability.

D. SUBSECTION 160(1) IS A HARSH COLLECTION REMEDY

***The Queen et al. v. Addison & Leyen Ltd. et al.*, 2007 DTC 5365**

This case involved an appeal to the Supreme Court of Canada from a decision of the Federal Court of Appeal. The corporation was reassessed in 1992 for outstanding tax, interest and penalties of over $3 million. In 1993, a Notice of Objection was filed on behalf of the corporation; the Minister never responded to the Notice of Objection. By 2001, the corporation’s outstanding tax liability had grown to almost $7 million.

In 2001, the Minister assessed the taxpayers vicariously for a corporation’s unpaid taxes under subsection 160(1) of the Act on the basis that between 1988 and 1992 the corporation sold its assets and made direct or indirect payments to the taxpayers in the form of dividends, management fees, and loan repayments. The taxpayers filed Notices of Objection to the assessments, which the Minister failed to respond to.

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In 2005, instead of filing a Notice of Appeal to the Tax Court of Canada, the taxpayers applied to the Federal Court of Canada for judicial review of the Minister's actions. The Court dismissed the application on the grounds that it lacked the jurisdiction to review the Minister's decision. The taxpayers then appealed to the Federal Court of Appeal, arguing that the Minister's decision to assess them under subsection 160(1) of the Act was an improper exercise of the discretion conferred on the Minister. The taxpayers argued that the long delay in issuing the Notice of Assessment had made it impossible for the taxpayers to seek indemnity from the corporation and compromised their ability to form a proper challenge to the assessment.

The Federal Court of Appeal allowed the taxpayers' appeals. The Court of Appeal held that the Federal Court has the jurisdiction to review an application that questions the exercise of the Minister's discretion to assess under subsection 160(1) of the Act. The decision was based on the fact that the provisions of subsection 160(1) of the Act provide the Minister with a harsh collection remedy which is subject to no statutory time limit.

The Crown appealed this decision to the Supreme Court of Canada. The Supreme Court allowed the Crown's appeal and held that judicial review is not available on the grounds of Ministerial delay in issuing a subsection 160(1) assessment. Where a taxpayer is assessed pursuant to subsection 160(1), the provision expressly authorizes the Minister to assess a taxpayer "at any time". The Minister's choice to exercise discretion under subsection 160(1) may be reviewable in some circumstances; however, it should remain a remedy of last resort and is not available based on grounds of lengthy delay before an assessment is made. The Supreme Court held that the taxpayers in this case should have followed the regular appeal process and appealed to the Tax Court of Canada, not the Federal Court of Canada, to resolve their tax liability issues in accordance with the procedures outlined in the Act.

The Supreme Court of Canada agreed with the reasoning of the Federal Court of Appeal in describing subsection 160(1) of the Act as a harsh collection remedy, although it overturned the Federal Court of Appeal decision on other grounds. In **Addison & Leyen Ltd. et al. v. The Queen et al.,** 2006 DTC 6248, the Federal Court of Appeal stated that subsection 160(1) of the Act may be considered a harsh collection remedy for the following reasons:

(i) There is no statutory time limit for an assessment under subsection 160(1) of the Act.

(ii) Even if the statutory conditions for the application of subsection 160(1) are met, the Minister has the discretion to assess or decline to assess a taxpayer under subsection 160(1) of the Act.

(iii) The Minister has the discretion to assess under subsection 160(1) without first employing or exhausting other collection remedies against the primary taxpayer.

(iv) The Minister has the discretion to assess any number of persons under subsection 160(1) of the Act for the same tax debt, in each case, up to the value of the property they have received from the tax debtor, less any consideration paid by the transferee.

(v) If there are a number of persons potentially liable under subsection 160(1) of the Act, the Minister may choose among them. Further, any rights of contribution and indemnity between transferees and the primary tax debtor must be resolved under the general law.

(vi) The Minister may assess under subsection 160(1) of the Act without alleging or proving an interest to avoid the payment of tax, and there is no due diligence defence.

(vii) A person assessed under subsection 160(1) of the Act cannot avoid liability by proving that he does not, or cannot, know or control the primary tax debtor’s affairs.

(viii) It is possible for subsection 160(1) to apply even if the events that gave rise to the primary tax liability occur after the transfer of the property that triggers the application of subsection 160(1) of the Act. This is because a person’s primary tax liability for a taxation year comes into existence at the end of the year, but subsection 160(1) of the Act may apply to a transfer of property that occurs at any time within that year.

(ix) The Act provides no procedure by which a recipient of property can seek a binding, early determination of a potential subsection 160(1) liability.

E. CHANGES IN LEGAL TITLE

Pursuant to subsection 160(1) of the Act a “transfer” must occur for joint and severable liability to arise. If the taxpayer can show that no transfer of legal title took place, the subsection 160(1) assessment will be vacated.

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F. ARM'S LENGTH TRANSFER

Subsection 160(1) of the Act only applies to non-arm's length transfers; therefore the imposition of joint and several liability under subsection 160(1) of the Act can be challenged on the grounds that the disposition was actually an arm's length transfer. Although the term "at arm's length" is used throughout the Act, the Act itself does not contain a precise definition of the term. Section 251 of the Act, which is the statutory provision for determining arm's length relationships, refers to three categories of arm's length relationships: (i) related persons; (ii) personal trusts and their beneficiaries; and (iii) persons not related.

The first category, “related persons”, includes individuals connected by blood relationship, marriage, common-law partnership or adoption. This category also includes corporations which have relationships with other corporations where control is shared or related in one of the scenarios identified in subparagraph 251(2)(c) of the Act. Corporations and individuals in which the individual controls or is related to a person who controls a corporation, are also considered “related persons” under subparagraph 251(2)(b) of the Act.

The second category of persons dealing at non-arm's length are “personal trusts and their beneficiaries”. Subsection 251(1)(b) of the Act provides that a taxpayer and a specified personal trust will be deemed not to deal with each other at arm's length if the taxpayer, or any person not dealing at arm's length with the taxpayer, is beneficially interested in the trust.

The third category of persons dealing at non-arm's length are “unrelated persons”. It is a question of fact whether unrelated persons are dealing with each other at arm's length. To ascertain whether the transfer was at arm's length, the Court will look at:

(i) whether there is an existence of a common mind which directs the bargaining for both parties to the transaction

(ii) parties to the transaction are acting in concert without separate interests;

(iii) One party has 'de facto' control over the other; and

(iv) both parties have the common motive of tax avoidance;

Note that the Act also provides for certain circumstances where partnerships, trusts, and shareholders can be considered as dealing at non-arm's length.

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G. TRANSFERS BETWEEN SPOUSES

Transfers of property between spouses occurring when the transferor has an outstanding tax liability may result in the transferee spouse being held vicariously liable for the tax owing under section 160 of the Act. A transferee spouse will be liable to satisfy the debt where there is no evidence of consideration provided for the transfer, even if the purpose of the transfer was unrelated to tax.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without the further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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