

Hot Topics in Tax Disputes

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Roadmap

- Strategic Document Management
- Mitigating the Cost of a Tax Dispute
- GAAR Update: the 25th Anniversary Edition



Tension in Managing Tax Documents

Expand

- Record keeping obligations
- Disclosure obligations
- Explain intention / purpose



Restrict

- Broad CRA powers
- Avoid giving roadmap

Reasons to Expand Collection and Retention

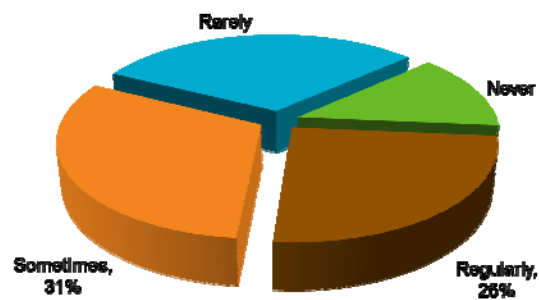
- Business, corporate governance & accounting
- Tax – general obligation to keep books and records
 - Specific obligations, e.g. contemporaneous documentation for transfer pricing
- Meaningful documentation to explain:
 - Intention / purpose
 - Internal rationale and thinking

CRA Powers

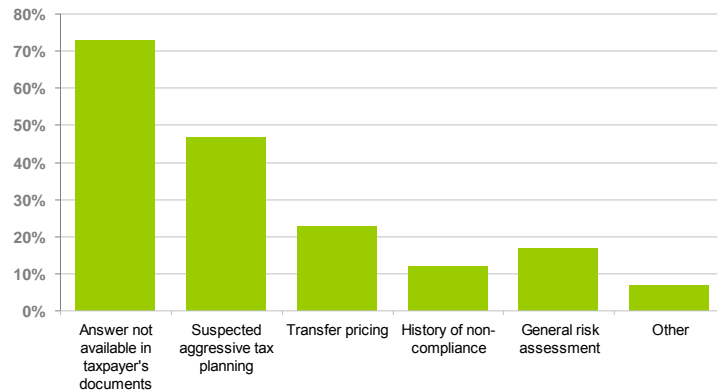
- Inspect, audit & examine books and records
 - Enter place where business carried on
 - Require owner / manager to answer questions
- Issue requirements to provide information and documents
- Most case law interprets these powers broadly

→ CRA becoming more sophisticated and aggressive

Frequency of Requests for Accounting Working Papers



Reasons for Requests for Accounting Working Papers



Trend Toward Increased Tax Avoidance Reporting

- OECD: traditional audits insufficient to tackle aggressive tax planning
- US
 - Reportable transactions regime
 - Report uncertain tax positions (UTP)
- UK
 - Disclose tax avoidance schemes with particular hallmarks
- Canada
 - Existing reporting for tax shelters, flow through shares
 - Proposed reporting for tax avoidance transactions
 - “Avoidance transaction” plus 2/3 hallmarks

Practical Tips for Managing Documents



Practical Tips for Managing Documents

Privilege

- Protocol to protect privileged documents
- Role of in-house counsel, lawyers in tax departments
- Distribution and segregation of documents
- Working with accountants
- Disclosure to financial statement auditors
- Lawyers' invoices

Practical Tips for Managing Documents

Records Management

- Creation, retention and destruction of documents
- Compliance with document management policies
- Electronically stored information (ESI) presents new challenges
- Related parties' documents – even if foreign based

Practical Tips for Managing Documents

Institutional Knowledge

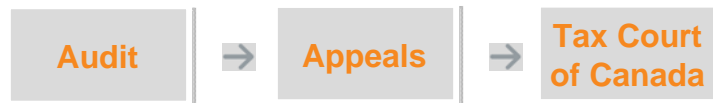
- Business reorganizations
- Increased turnover of employees
- Changes in software and systems

Practical Tips for Managing Documents

Compelling Evidence

- Front-load analysis of issues and arguments
- Identify key people
- Early collection of documents

Mitigating the Cost of a Tax Dispute



Audit

- Managing the scope of CRA audit queries
- Narrowing the issues
- Effective use of submissions
 - Framework can be used for notice of objection
 - Drafted with an eye to possible referral to more senior CRA personnel
 - Can be read as a stand-alone document
 - Likely to be first document read by new CRA personnel

Audit (cont'd)

- Managing multiple year issues and alternative assessing positions
- Settlements
 - Flexibility in structure
 - Flexibility in granting interest relief

Appeals

- Meeting with CRA Appeals to identify areas of disagreement (or where CRA is inflexible)
 - Is this going to be a useful exercise?
 - Where should the efforts be focused?
 - Avoid negotiating against yourself
- Requesting CRA Audit Report (T20) and Appeals Report (T401)
- Use of HQ referrals

Appeals (con'd)

- Seek materials pursuant to *Access to Information Act*
- Assess downside risk for non-deductible arrears interest
 - Pay outstanding amounts if appropriate

Tax Court of Canada

- Using agreed statement of facts
- Using requests to admit
- Forgoing discovery of CRA representative
- Cost implications of settlement offers
 - Recent case law: *CIBC World Markets*, *TransAlta*
- Use of settlement conference
- Is a section 173 reference appropriate / available?

25 Years of the GAAR – Some Statistics

- GAAR became reality on September 13, 1988
 - Reaction to Stupart Investments
- GAAR committee approval required for reassessments
 - Committee includes senior CRA, Finance and Justice officials
- GAAR committee statistics (as of November 20, 2012)
 - Considered GAAR in 1,080 cases
 - Applied GAAR on 822 occasions (76%)
 - GAAR approvals rising
 - As of Sept. 2003: GAAR approved 370 out of 573 reviews (65%)
 - In 2012: GAAR approved 77 times out of 80 (96%)
 - GAAR often a secondary assessing position – 453 cases (55%)

GAAR Committee Reviews 1988 – 2012

| | GAAR | No GAAR | Total | | GAAR | No GAAR | Total |
|----------------------------------|------|---------|-------|------------------------|------------|------------|--------------|
| Surplus strips | 194 | 32 | 226 | Foreign tax credit | 15 | 3 | 18 |
| Kiddie tax | 88 | 6 | 94 | Offshore trusts | 15 | 1 | 16 |
| Income splitting | 14 | 3 | 17 | Charitable donations | 16 | 10 | 26 |
| Losses, stop losses | 10 | 5 | 15 | Capital gain | 25 | 10 | 35 |
| Losses, capital and non-capital | 42 | 19 | 61 | Interest deductibility | 19 | 17 | 36 |
| Loss creation via stock dividend | 91 | 0 | 91 | Debt parking | 17 | 7 | 24 |
| Cross-border lease | 11 | 0 | 11 | Debt forgiveness | 33 | 10 | 43 |
| Part XIII tax | 3 | 9 | 12 | Part I.3 tax | 38 | 11 | 49 |
| Kiwi loan | 14 | 0 | 14 | Provincial GAAR | 0 | 3 | 3 |
| Indirect loan | 28 | 3 | 31 | Partnership issues | 26 | 8 | 34 |
| Treaty exemption claim | 5 | 2 | 7 | Miscellaneous | 112 | 96 | 208 |
| Tower structure | 6 | 3 | 9 | Total | 822 | 258 | 1,080 |

Source: CRA – Canadian Tax Foundation Nov. 2012

GAAR Cases, Year Ended Sept. 30, 2012

| | GAAR |
|----------------------------------|-----------|
| Surplus strips | 56 |
| Loss creations | 9 |
| Losses (capital and non-capital) | 3 |
| Income splitting | 3 |
| Foreign tax credit | 1 |
| Kiddie tax | 1 |
| Offshore trusts | 1 |
| Charitable donations | 1 |
| Capital gain | 1 |
| Tower structure | 1 |
| Miscellaneous | 0 |
| Total | 77 |

Source: CRA – Canadian Tax Foundation Nov. 2012

GAAR Before *Canada Trustco*

- 70% of cases decided in favour of the taxpayer prior to SCC decisions in *Canada Trustco* and *Mathew*
- No appeals overturned by FCA

| | TCC | FCA | Final | Final (%) |
|-----------------|-----|-----|-------|-----------|
| Taxpayer | 12 | 4 | 12 | 70% |
| Crown | 5 | 2 | 5 | 30% |
| Total | 17 | 6 | 17 | |

GAAR at the SCC

- *Canada Trustco* and *Mathew* – 2005
 - Sets the blueprint for GAAR analysis
 - Mixed success: *Canada Trustco* won, *Mathew* lost
- *Lipson* – 2009
 - Strongly divided Court issued three sets of reasons
- *Copthorne Holdings* – December 2011
 - Crown wins, TCC and FCA upheld
 - Unanimous united Court unlike *Lipson*
 - Reiterates *Canada Trustco* blueprint
 - Suggests limited use for extrinsic aids
 - Broad scope to “series of transactions”

GAAR Since *Canada Trustco*

- Since *Canada Trustco* little change:

| | TCC | FCA (Rev'd) | SCC | Final | Final (%) |
|-----------------|-----|----------------|-----|-------|-----------|
| Taxpayer | 30 | 10 (1) | 1 | 29 | 69% |
| Crown | 12 | 7 (2) | 3 | 13 | 31% |
| Total | 42 | 17 (3) | 4 | 42 | |

- Success on appeal rare – only 3 GAAR cases overturned:
 - *MacKay* – 2009
 - *Lehigh Cement* – 2010
 - *Global Equity Fund* – 2012
 - None of these were overturned on the facts

GAAR: *Canada Trustco* to *Cophorne*

GAAR applies:

- Mathew* (SCC)
 - Loss transfer
- Desmarais* (TCC)
 - Surplus strip
- CECO* (TCC)
 - Partnership / disguised proceeds
- OGT Holdings* (QCA)
 - Quebec shuffle

GAAR does not apply:

- Canada Trustco* (SCC)
 - Cost, economic substance
- Evans* (TCC)
 - Surplus / income strip
- Univar* (TCC)
 - Tiered financing
- Overs* (TCC)
 - Reverse attribution / interest
- McMullen* (TCC)
 - Capital gains strip
- MIL* (FCA)
 - Treaty shopping

GAAR: *Canada Trustco to Copthorne*

GAAR applies:

MacKay (FCA)

- Withholding tax

Lipson (SCC)

- Reverse attribution / interest

Antle (FCA)

- Capital gains step-up, Barbados trust

GAAR does not apply:

Landrus (FCA)

- Terminal loss recognition

Remai (FCA)

- Charitable donations

Collins & Aikman (FCA)

- Surplus stripping

Maréchaux (FCA)

- Leveraged donation
- GAAR argued but not needed

Garron (FCA)

- Barbados trust

GAAR: *Canada Trustco to Copthorne*

GAAR applies:

Triad Gestco (TCC)

- Value shift / capital loss

1207192 Ontario (TCC)

- Value shift / capital loss

Copthorne (SCC)

- PUC duplication

GAAR does not apply:

Lehigh Cement (FCA)

- Withholding tax

Husky (ABQB)

- Provincial interest shift

Canada Safeway (ABQB)

- Finco interest shift

Envision Credit Union (FCA)

- Broken amalgamation
- GAAR argued but not needed

Global Equity Fund (TCC)

- Value shift / business loss

GAAR Post-Copthorne

- *McClarty Family Trust* – March 2012
 - Taxpayer wins
- *Spruce Credit Union (TCC)* – October 2012
 - Taxpayer wins
- *Canada Safeway / Husky (ABQB)* – July 2012
 - Both taxpayers win
 - Leave to appeal to SCC denied March 7, 2013
- *MacDonald (TCC)* – April 2012
 - Taxpayer wins
 - FCA appeal heard - March 18, 2013
- *Triad Gestco / 1207192 Ontario / Global Equity Fund (FCA)* – October 2012
 - Crown wins trilogy of FCA “paper loss” cases
 - In *Global Equity Fund* FCA reversed taxpayer’s win at TCC

McClarty Family Trust (TCC)

- Conversion of dividends into capital gains to avoid “kiddie tax” (120.4)
 - Law changed in 2011 no longer possible
- Tax benefit conceded at trial
- Angers J: not an avoidance transaction
 - Evidence that taxpayer was in fear of litigation from former employers
 - Intention of series of transactions was to creditor-proof against law suits
 - Crown argued creditor-proofing could have been done in less tax advantageous manner, Court disagreed:
 - [52] To hold that the sale of the shares should be considered an avoidance transaction because some alternative transaction may have achieved a similar result but with higher taxes would, in my opinion, be inconsistent with the Supreme Court’s comments in *Canada Trustco* and the Explanatory notes relating to section 245 of the *ITA*.
 - [53] It is my opinion that every single transaction constituting the series was made with a *bona fide* purpose other than to obtain the tax benefit. The intention of protecting the assets was the primary motivating element behind each transaction.

Spruce Credit Union (TCC)

- Facts
 - Taxpayer was one of 54 regulated credit unions in BC
 - Two different BC insurance bodies protected credit unions:
 - Credit Union Deposit Insurance Corporation (“CUDIC”)
 - Stabilization Central Credit Union of British Columbia (“STAB”)
 - Each BC regulated credit union was a shareholder of STAB
 - BC Financial Institution Commission changed CUDIC/STAB coverage ratios
 - STAB decided to pay credit unions dividends to fund CUDIC coverage increase
 - Dividends paid in two parts due to tax uncertainty
 - Partially blessed by GAAR committee; separate dividend paid for uncertain portion
 - Taxpayer took deduction for both dividends under s.112
- Minister assessed under GAAR saying s.112 deduction a tax benefit
- Boyle J: not an avoidance transaction
 - Purpose of dividends was to increase CUDIC coverage not to obtain tax benefit
 - Payment of separate dividends does not affect tax consequences
 - Not an avoidance transaction “to choose an option that is one with the least tax cost”

Canada Safeway / Husky (ABCA)

- Facts
 - Provincial GAAR cases
 - Companies replaced retained earnings with loans from related party
 - Loans from related BVI corporations having PEs in Ontario
 - Dividends paid from Ontario PEs to return funds to Alberta
 - Deductions on interest taken in Alberta
 - Interest payments tax-free in Ontario; dividends tax-free in Alberta
 - No change in federal taxes but decreased Alberta taxes from interest expense
 - Plans unwound when Ontario laws changed
- Hunt J: not abusive of 20(1)(c) and 112(1)
 - Alberta argued abuse because lender paid no tax in Ontario
 - But 20(1)(c) applies only to the borrower. Other taxpayers taxation irrelevant
 - Nothing in 112(1) suggests dividend deductions limited to taxable income streams
 - Differing provincial tax policies fundamental part of Canadian federation

MacDonald (TCC)

- Moved to US for spouse. Subject to capital gains on emigration
- Had capital losses to apply against Canadian gains. But would later be taxed again in US for same gains
- “pipeline” strategy using brother-in-law to convert shareholder interest into creditor interest of his professional corporation to avoid US double tax
- Court rejected argument that goal of minimizing foreign tax was not a avoidance transaction
 - Primary purpose was to use available capital losses
- Hershfield – Not abusive
- Taxpayer had legitimate available capital losses that could be used against capital gains on emigration
- Scheme allowed for use of those same losses. To disallow the use of legitimate losses (denial of Tax Benefit) would be “bizarre”
- Taxpayer also successful on 84(2)

Paper Loss Trilogy

- Facts
 - *Triad Gestco / 1207192 Ontario*
 - Common shares created in exchange for assets
 - Stock dividends paid to create class of preference shares to shift value
 - Common shares then sold to create capital losses
 - *Global Equity Fund*
 - Security trader variation
 - Stock dividends reported as business income
 - Deduction taken on subscription price of common shares to create non-capital losses

Paper Loss Trilogy

- *Triad Gestco / 1207192 Ontario*
 - Tax Court of Canada
 - Both argued that transactions had other primary purposes (estate freeze / creditor proofing) and should not be seen as avoidance transaction
 - Both found to be avoidance transaction and abusive but for different reasons
 - Federal Court of Appeal
 - Both decisions upheld on appeal (Crown wins)
 - *1207192 Ontario* sought leave to SCC – denied March 28, 2013

Paper Loss Trilogy

- *Global Equity Fund*
 - Tax Court of Canada
 - Again taxpayer argued creditor proofing but avoidance transaction found
 - Crown failed in its burden to establish clear policy in sections 3, 4, 9, or 111 that “only real losses outside the economic unit may be deducted”
 - Taxpayer won but seemingly on a technicality
 - Court (obiter) if a policy had been established then the second part of the abuse test would have been met as the transactions were “vacuous”
 - Federal Court of Appeal (Rare Reversal)
 - Crown used subsection 152(9) to introduce new arguments
 - Court determines textual, contextual and purposive interpretation of sections 3, 4, 9 and 111 lead to rationale that “at the very least, be an air of economic or business reality associated with that loss”
 - clear departure from SCC jurisprudence respecting legal form over economic substance. Is case an outlier?
 - Factual finding by TCC on vacuity of transactions is evidence of abuse
 - Costs awarded to taxpayer, despite loss, due to new Crown arguments

***Birchcliff Energy* (TCC December 20, 2012)**

- Background:
 - Procedural motion in GAAR matter
 - Taxpayer sought particulars from Crown on the purpose of the abused statutory provisions for which the GAAR was being applied
 - Crown fought:
 - Policies are conclusions of law
 - Only facts need be disclosed in pleadings
 - Crown not restricted to arguing those provisions at trial
- Miller J allowed motion in part, finding that:
 - Basis for GAAR assessment matter of historical fact
 - Policies relied upon making the assessment must be provided but only those historically considered
 - Policies would be “other material facts” and not “assumptions” therefore Onus on Crown at trial

Trends in GAAR Litigation

- Increased focus by Courts on policy of provision(s) allegedly abused
 - *Cophorne*
 - All three of levels of court considered different provision offended
 - *Global Equity*
 - Disagreement between courts as to policy of the provisions
 - *Birchcliff Energy*
 - Crown required to disclose specifics in advance of discovery

Trends in GAAR Litigation

- Avoidance transactions are avoidable – do not concede
 - *McClarty Family Trust*
 - *Spruce Credit Union*
 - *Swirsky* (March 2013 – in obiter)

Trends in GAAR Litigation

- Decisions of TCC usually final
 - GAAR cases factual
 - Despite court comments to the contrary GAAR is a smell test
 - Judges don't know what abuse is "until they see it."
 - Evidence and framing of facts matter. Set the smell
 - Difficult to overturn factual errors: test is palpable and overriding error



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