Abusive Tax Planning: 
The Problem and the Canadian Context

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Abusive Tax Planning: The Problem and the Canadian Context
(Background Paper)

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ABUSIVE TAX PLANNING: THE PROBLEM AND THE CANADIAN CONTEXT

1 INTRODUCTION

In response to the global economic and financial crisis, governments of the G20 member countries announced exceptional economic measures that are resulting in large budget deficits. At the same time, to restore balanced budgets as quickly as possible, they decided to reduce their tax losses, in particular by more vigorously discouraging the use of tax havens, or by tightening their legislation so they can better fight abusive tax avoidance at home, or both. The Canadian federal government intends to take part in international efforts to combat tax havens, but it is not planning to amend its statutory tools to combat abusive tax avoidance. Some experts think, however, that the government could be better equipped in this regard.

This document focuses on the problem of aggressive or abusive tax planning (ATP), in general and in the Canadian context. It provides examples of measures that governments in Quebec, the United States and the United Kingdom have adopted to combat ATP.

2 AGGRESSIVE TAX PLANNING

The ATP phenomenon is not new. In 2004, the Canada Revenue Agency (CRA) listed ATP as one of the five main tax compliance risks in Canada. In the report it submitted to Parliament in January 2008, the CRA noted that in the 2006–2007 fiscal year, it had issued 14,600 revised assessments, resulting in $1.4 billion in additional taxes, and that it was able to do this in part as a result of the emphasis placed on early analysis and identification of cases of ATP.

In fact, ATP has been gaining ground in Europe and North America for some years. This can be explained by the gaps between the tax rates applied by the different tax authorities, a risk–return ratio that is favourable to taxpayers, corporations’ need to be competitive at the international level and the activities of specialized firms that are becoming increasingly expert in this area.

In September 2006, in what is referred to as the Seoul Declaration, the members of the Organisation for Economic Co-operation and Development (OECD) stressed the risk represented by ATP:

Enforcement of our respective tax laws has become more difficult as trade and capital liberalisation and advances in communications technologies have opened the global marketplace to a wider spectrum of taxpayers. While this more open economic environment is good for business and global growth, it can lead to structures which challenge tax rules, and schemes and arrangements by both domestic and foreign taxpayers to facilitate non-compliance with our national tax laws…
It is against this backdrop that some governments have changed their fiscal policy and legislative framework relating to ATP.

3 CANADIAN FISCAL CONTEXT

The context in which ATP appears in Canada includes the tax regime itself, the legislative tools available, including the way they are applied and how they are interpreted by the courts, and the problem of the lack of harmonization among the tax rules in Canada.

3.1 THE CANADIAN FEDERAL TAX SYSTEM

The Canadian tax system, of which the Income Tax Act (ITA) is the cornerstone, is a self-assessment scheme: each taxpayer determines his or her own income tax payable and then reports it to CRA, which is responsible for checking the taxpayer’s return and, where necessary, issuing a revised assessment. Self-assessment significantly reduces the costs of administering the system.

The system recognizes that taxpayers are entitled to carry out tax planning. Taxpayers may organize their affairs in such a way as to reduce the taxes they must pay as much as possible, unless doing so violates the provisions of the ITA, a tax treaty or another fiscal measure. However, the right to engage in tax planning opens the door for taxpayers who may want to succumb to the temptation of ATP.

Tax authorities must therefore identify the risks and set priorities for their activities, since complete audits of every tax return would quite simply be impossible, or at least inefficient. It is particularly important for the tax authorities to identify those risks and priorities because they bear the burden of determining whether taxpayers are in compliance with the provisions used to seek the tax benefits the taxpayers have claimed. This was the opinion of the Supreme Court of Canada in Shell Canada Ltd. in this regard:

Absent a specific provision to the contrary, it is not the courts’ role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. ... The courts’ role is to interpret and apply the Act as it was adopted by Parliament.

3.2 LEGISLATIVE TOOLS FOR COMBATTING ABUSIVE TAX PLANNING

The ITA contains numerous general rules of varying degrees of complexity designed to guide taxpayers’ conduct in their tax planning.

3.2.1 SPECIFIC ANTI-AVOIDANCE RULES

For greater clarity and to ensure the integrity and fairness of the tax system, Parliament has attempted to foresee undesirable situations and has introduced specific rules to prevent them from occurring; these are known as specific
anti-avoidance rules. The main advantage they offer is that they apply to a specific area and do not call for interpretation, which makes them easy to apply. On the other hand, because it is impossible to foresee all situations and all techniques that taxpayers and their tax advisors will use to circumvent the provisions of the ITA, most often, tax authorities respond by sealing a crack in the Act that has been exploited for some time.

While the specific anti-avoidance rules are an effective way of combatting ATP when they are applied to specific situations, their effectiveness depends on Parliament’s ability to foresee and rapidly detect all tax planning that is contrary to the spirit of the law.

3.2.2 General Anti-Avoidance Rule

The growing complexity of Canadian tax legislation means that it is difficult, if not impossible, for Parliament to use specific anti-avoidance measures to counter every situation that might arise from the use of the provisions of the legislation. A number of tax authorities are therefore adopting general anti-avoidance rules to put an end to tax planning that adheres to the letter of the law but not its spirit. The Government of Canada uses the General Anti-Avoidance Rule (GAAR) set out in section 245 of the ITA.

The GAAR was enacted in 1988, primarily in response to the 1984 decision in Stubart Investments Ltd. v. The Queen. In that decision, the Supreme Court of Canada rejected a literal reading of the ITA, and at the same time rejected the business purpose test, where the literal reading would have reduced tax on operations with a bona fide business purpose. The Court suggested that the business purpose test be replaced by guidelines to limit unacceptable tax avoidance arrangements.

The government was of the view that Stubart did not adequately address the problem, so to respond to the concerns expressed by the Department of Finance Canada, which said it did not have adequate tools to combat ATP, the government introduced the GAAR in the 1987 tax reform.

It should be noted that a taxpayer to whom the GAAR applies is not liable to a penalty: the only amount claimed is the difference between the tax payable according to the self-assessment and the revised assessment and interest. This is where the Government of Canada differs from some other tax authorities, which add penalties to the tax and interest payable, and it is a reason why some believe that the Canadian government could be better equipped to combat ATP.

3.2.2.1 Application

The GAAR can be used to eliminate a tax benefit, but only if the situation meets each of the following criteria:

- The first step is to determine whether the transaction gives rise to a tax benefit.

In cases where a deduction from taxable income is sought, the tax benefit is obvious, since a deduction automatically results in a reduction of tax. In other
cases, whether there is a tax benefit arising from one “arrangement” may have to be determined using a comparison with another arrangement. An example would be designating an amount as a capital gain rather than income from a business, which would result in more favourable tax treatment.

- The second step is to determine whether the transaction is an avoidance transaction, that is, one that is not undertaken primarily for a “bona fide” purpose.

In these cases, it must be determined whether a taxpayer has reduced, avoided or deferred an amount of tax payable under the ITA. The courts have held that family purposes or investments, in addition to business purposes, are acceptable as bona fide purposes. The legislation is meant to allow numerous schemes that have no business purpose to continue, such as registered retirement savings plans (RRSPs), and it acknowledged that many provisions of the ITA confer legitimate tax benefits, in spite of the fact that there is no bona fide business purpose. That is the effect of the general wording of the GAAR, as opposed to wording that would have laid down a general anti-avoidance test with exceptions applicable to particular schemes, such as transactions affecting RRSPs.

- The third step is to determine whether the avoidance transaction is abusive.

The GAAR essentially targets transactions carried out primarily for reasons that do not adhere to the spirit of the ITA. An avoidance objective is necessary for the action to be classified as a violation of the GAAR, but the existence of that objective is not decisive for the GAAR to apply. It is only when the courts determine that the transaction as a whole contravenes the spirit of the relevant provisions – that is, whether it is abusive or not – that the motivation, purpose and economic raison d’être are taken into account. The Supreme Court has stated that this is the main difficulty with the GAAR:

It is this requirement that has given rise to the most difficulty in the interpretation and application of the GAAR … The section is cast in terms of a double negative, stating that the GAAR does “not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse … or an abuse.”

The GAAR is tempered by the use of the word “reasonable,” which indicates that the Minister or the court has some latitude in deciding whether there has been abuse. It does not give a specific definition of abuse.

All three requirements must be met in order for the GAAR to result in elimination of a tax benefit.

3.2.2.2 INVOLVEMENT OF THE COURTS

In the Canadian legislative context, the GAAR generally prohibits abusive tax avoidance, and that prohibition is superimposed to some extent on the literal application of certain provisions of the ITA, where, based on the context and purpose, that application may be regarded as abusive. In fact, the GAAR is an attempt to draw a demarcation line between the legitimate maximum reduction of tax and abusive tax avoidance. Although it tends to make the Canadian tax system fairer, the rule involves an element of uncertainty for Canadian taxpayers; even if
they abide by all of the relevant legislative provisions, they risk receiving a revised assessment because they failed to adhere to the spirit of the law, as it is interpreted by the tax authorities.

The delicate task of identifying the spirit of the law and determining whether a taxpayer has complied with it or not is left to the courts, sometimes with unexpected results. In the past, the courts have criticized Parliament for the lack of clarity in legislative provisions, which left them the careful work of determining the intention of Parliament and the spirit of the law, as well as causing uncertainty for taxpayers. In Canada Trustco Mortgages v. Canada, the Supreme Court made the following comment regarding the GAAR:

To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the Income Tax Act would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped.21

Laudable as may be the main objective of the GAAR – to protect the tax base and better distribute the tax burden among taxpayers – tax authorities cannot count on the courts to make up for flaws in the legislation, even if the consequences of those flaws are unfavourable in terms of public finances. Justice Rothstein, speaking for the majority in McLarty, stated:

In reassessment cases, the role of the court is solely to adjudicate disputes between the Minister and the taxpayer. It is not a protector of government revenue. The court must decide only whether the Minister, on the basis on which he chooses to assess, is right or wrong.22

The courts interpret tax legislation by reading “the words of an Act … in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament.”23 In other words, they must combine those approaches within a framework that reflects the intention Parliament had when it enacted the GAAR and produces uniform, foreseeable and fair results for taxpayers and the government.

3.3 IMPACT OF THE ABSENCE OF HARMONIZATION OF TAX RULES IN CANADA

In the Canadian tax system, the federal government and the provincial governments share the same tax base. With the exception of Quebec, which has its own tax legislation, the provinces collect their personal income taxes from federally taxable income. For corporate income tax, the provinces have their own legislation. Quebec and Alberta collect their own income tax, while the other provinces have delegated that administrative responsibility to the federal government.

Harmonization of federal and provincial tax rules and policies is not complete, and that situation creates loopholes that benefit taxpayers. Some ATP is designed precisely to take advantage of the cracks created by the autonomous nature of some provincial legislation.
An example of ATP that allowed taxpayers to completely avoid any provincial tax was the “Quebec Shuffle.” This form of ATP exploited the ability to make a separate election at the federal and provincial levels concerning the amount of the agreed figure in a transfer of shares in a Quebec corporation to, for example, a corporation resident in another province, such as Ontario. After the transaction, the two corporations would merge, paying only federal income tax on the capital gain, and cancelling the shares of the Ontario corporation. Another example is the “Quebec Truffle,” which used a separate election under federal and provincial legislation regarding the residence of trusts.

Although tax authorities discovered these strategies and remedied the situations through retroactive legislative changes, these examples of ATP deprived the public purse of significant tax revenue. For example, figures in the order of $500 million, for all Canadian provinces, have been advanced in the case of the “Quebec Truffle.” It may be that tax experts have already set up other strategies of the same nature to take advantage of the fact that tax rules in Canada are not harmonized.

4 MEASURES ADOPTED BY OTHER TAX AUTHORITIES

As we noted earlier, ATP is a phenomenon that has affected numerous tax authorities. Some have taken measures to make the risk–return ratio less affordable and thus deter taxpayers from using it. For the purpose of comparison, since Canada does not impose penalties in the case of assessments that are revised because of ATP, this section provides a brief overview of the legislative tools adopted by Quebec, the United States and the United Kingdom to deter the use of ATP.

4.1 Quebec

In October 2009, after a period of consultation on ATP, the Government of Quebec announced new measures modelled on the ones in force in the United States, the United Kingdom and Australia. The new rules are in addition to the anti-avoidance provisions that already exist in Canada, and they will apply only in Quebec.

Essentially, the Quebec government is increasing the financial risk for taxpayers who engage in ATP by adding to the GAAR a penalty representing 25% of the tax a taxpayer engaged in ATP had sought to avoid. In addition, promoters will be subject under the GAAR to a penalty of 12.5% of the amount he or she received in connection with the transaction. The penalties may be avoided, however, if there is prior disclosure of the transaction to Revenu Québec.

Where mandatory disclosure of a confidential transaction or a transaction for which payment is conditional is not made, the penalties may be as high as $100,000. Revenu Québec will also not be subject to any time limit for reviewing any undisclosed transaction.

The Government of Quebec states that a major purpose of the requirement for mandatory disclosure of transactions at high risk of being abusive tax planning is to deter efforts by tax advisors to develop a new business model based on marketing
“standardized tax products.” The requirement is also intended to give tax authorities speedy notice of planning schemes that are introduced on the market, so that, if necessary, prompt legislative action can be taken.

The government has also extended the period during which Revenu Québec may review a transaction covered by the GAAR by three years. However, the longer review period will not apply where there has been mandatory or preventive disclosure of the transaction to Revenue Québec.

4.2 United States

Since 1984, US tax legislation has included mandatory registration of potentially abusive tax shelters with tax authorities. In recent years, the list of transactions for which mandatory disclosure applies has grown significantly. Thanks to mandatory registration, US tax authorities are able to intervene promptly when ATP arrangements are being established, enabling them to avoid substantial revenue losses resulting from the use of ATP by taxpayers over a long period.

In addition, to deter taxpayers and promoters who might take an interest in the “ATP market,” US tax authorities impose penalties on rule breakers. The penalties may be the higher of 30% of the underestimated tax payable, or US$200,000, for the taxpayer and US$200,000, or up to 50% of gross income from the transaction, for the promoter.

4.3 United Kingdom

As in the US, legislation in the UK includes a mechanism for mandatory disclosure of potentially abusive tax transactions. Unlike in the US, however, disclosure rules in the UK primarily target ATP promoters, and to deter the promoters, the disclosure rules also involve penalties. The initial penalty is £5,000, to which a late penalty of £600 per day may be added.

5 Conclusion

Given that abusive tax planning appears to be gaining ground, and tax revenue is declining, Canada might consider reviewing some aspects of its fiscal regime to provide better protection for the interests of taxpayers as a whole. One possible measure would be to make the risk–return ratio for ATP more unfavourable, in particular by levying penalties, as some tax authorities already do, and thus deter taxpayers from engaging in ATP.

More generally, and from a more long-term perspective, it might be wise to address the difficulties that sometimes arise both from the delicate situation in which the courts may find themselves because of the lack of clarity in certain tax provisions and from the loopholes created by the fact that tax provisions within Canada are not harmonized.
In conclusion, we would note that taxation is a complex and constantly changing field, and is the basis for funding the public services around which our society is organized and which in part determine our quality of life. An effective tax regime makes it possible to maximize a country’s economic potential, take concrete action to promote human values like compassion and mutual responsibility, and remain economically competitive on the international scene.

NOTES

1. According to the definition used by OECD member countries, a “tax haven” is a taxation system characterized by no or low tax rates, laws that protect banking secrecy and a lack of transparency in the administration of the laws.

2. In tax law, a distinction is made between “tax avoidance” and “tax evasion.” While both enable the taxpayer to pay less tax, tax avoidance does not directly violate any particular statutory provision, while tax evasion violates one or more rules and accordingly is intrinsically illegal. On the other hand, tax avoidance becomes “abusive” when a taxpayer organizes his or her affairs in a way that adheres to the letter of the law, but not the spirit.

3. Tax planning refers to arrangements to reduce taxes in ways that are consistent with the letter and spirit of the law. Tax planning becomes aggressive or abusive when the result is abusive tax avoidance, that is, when actions are contrary to the spirit of the law while complying with the letter of the law.

4. The other tax compliance risks noted by CRA in 2004 were the underground economy, GST/HST high-risk compliance, non-filers/non-registrants, and remittance non-compliance (voir CRA, Canada Revenue Agency Annual Report to Parliament, 2007-2008, p. 19). It is worth noting that in 2005, CRA’s budget was increased by $30 million to establish 11 centres of expertise to combat the use of ATP using international transactions, and particularly the use of tax havens. See Department of Finance, Chapter 4, “A Productive, Growing and Sustainable Economy.” Budget 2005 – Budget Plan.


7. “Their affairs” means anything that could affect the tax payable by a taxpayer, such as the way assets are held, the creation of trusts, the structure of estates and gift planning.


10. The business purpose test holds that a tax transaction must be motivated by a business purpose and not purely by tax reduction considerations.


12. The term “arrangement” is used in the Income Tax Act R.S., 1985, c. 1 (5th Supplement) [ITA] in the general sense of “scheme” or “provision,” but it is not defined.

13. A capital gain is only 50% taxable, and it may be reduced, for example, by using a capital loss; this is not the case for income from a business.
14. “Bona fide purpose” is the term used in the ITA, subsection 245(3), but it is not defined there.

15. See Stubart Investments Ltd. v. The Queen, referred to earlier, which is the origin of the GAAR.

16. ITA, subsection 245(3).

17. Ibid., subsection 245(4).


19. Ibid., para. 37.

20. The courts have generally applied the GAAR to patently abusive transactions, and given the taxpayer the benefit of the doubt.


24. The “Quebec Shuffle” was brought to light by tax authorities in 1996. A brief explanation of this form of ATP can be found in Government of Quebec, Finances Québec, Aggressive Tax Planning, Working Paper, January 2009, p. 6.

25. The separate election was made under para. 85(1)(a) of the ITA and para. 522(a) of the Quebec Income Tax Act.

26. The “Quebec Truffle” was brought to light by tax authorities in 2006. A brief explanation of this form of ATP can be found in Government of Quebec, Aggressive Tax Planning (2009), pp. 6 and 7.


29. United States, Internal Revenue Code, in particular ss. 6011, 6111, 6112, 6501, 6662A, 6664, 6707, 6707A and 6708.