More generally, lack of clarity frustrates taxpayers, advisers, and many government officials. Ambiguity causes uncertainty, and uncertainty tends to discourage business investment. At the same time, lack of certainty may perversely encourage aggressive planning by adventurous taxpayers that are willing to live with uncertainty in the hope that their transaction falls on the right side of an ill-defined grey line. None of this is healthy for the tax system or the broader economy.

Planning uncertainty tends to foster tax disputes. When the rules are clear, parties are more likely to avoid controversy and settle their disputes. Clear rules tend to prevent disputes. A recent IMF/OECD report strongly endorses tax certainty as “a priority issue for taxpayers and tax administrations alike” and recommends that governments shift their focus “from dispute resolution to dispute prevention.” If tax administrations can provide prompt, clear, and helpful guidance—guidance that taxpayers can rely on—the instances of disputes will decline. The IMF/OECD report concurs. It identifies the “[a]vailability of a tax ruling function with clear and straightforward rules” as an important feature of “good governance in revenue administration.”

Both in future reforms of the tax system and in the administration of current tax laws, Canada’s governments should adopt tax certainty as an explicit benchmark when deciding on tax measures. Measures that exacerbate uncertainty should be accepted only if no reasonable alternatives exist. At the very least, tax certainty should be one of the criteria (in addition, of course, to revenue generation, preservation of the system’s integrity, administrability, and fairness) by which any proposed tax measures should be judged.

The remainder of this article describes the roles of the Department of Finance and the CRA, respectively, in contributing to (or reducing) uncertainty in the tax system. The article concludes with some recommendations for future reforms.

**Finance’s Role in Tax Certainty**

The Problem of Legislative Overreach

The role of Finance, broadly speaking, is to give effect to the government’s tax policies through legislative measures that are considered by Parliament and passed into law. Officials in the Tax Legislation Division have the challenging task of drafting this legislation. People outside the tax community often
have profound misconceptions about tax legislation and how it is drafted. Few people understand why tax law is so complex or grasp that easy fixes are rare. Many seem to think the law is littered with “loopholes” that need to be “closed,” and, even worse, they habitually conflate tax evasion, a criminal offence, with tax avoidance, the legitimate and appropriate activity of arranging one’s affairs to minimize tax. This fuzzy thinking tends to pressure governments to enact new anti-avoidance rules that will shut down perceived tax-saving opportunities and protect the integrity of the tax base. These pressure-driven measures often have the effect of further complicating already complex legislation.

Tax advisers tend to dislike these kinds of measures, although most advisers understand the need for tax laws that cannot readily be skirted by manipulative or creative planners whose clients are willing to take significant risks in undertaking tax-motivated transactions. Most people in the tax community accept that amendments are sometimes needed to protect the integrity of the tax base.

The trouble arises when Finance reacts to perceived gaps by proposing fixes that go too far and create new uncertainties for ordinary transactions. This phenomenon of legislative overreach, which the public tends to be unaware of (or at least uninterested in), discredits the tax system. It is a growing problem that significantly erodes planning certainty in a way that tends to diminish taxpayers’ overall trust in tax laws—a critical factor in a self-assessment system.

How does this problem of legislative overreach typically come about, and what are its consequences? The example of subsection 55(2) of the ITA, although relevant only in a corporate context, is generally instructive.

Consider a wholly owned corporate group that wants to distribute cash up the corporate chain for real commercial reasons—say, to distribute dividends to shareholders. This movement of cash has no tax motivation whatsoever. Suppose the corporate group has existed for decades and has no plan to sell any of its operations. This distribution should be a straightforward transaction in which dividends are paid from the cash-rich subsidiary up the corporate chain to the entity that needs the cash.

Before 2015, the analysis of this transaction was straightforward and predictable. Each corporation in the chain would claim a 100 percent dividends-received deduction so that the dividend would flow tax-free within the corporate group, as it should. (The underlying earnings or gains would already have been subjected to income tax, so any further tax on intercorporate distributions would amount to double taxation.) If a very large distribution were planned, a prudent tax director might have felt the need to check the anti-avoidance rule in subsection 55(2). This rule, added in 1980, was designed to prevent the conversion of (otherwise taxable) capital gains from a third-party sale into tax-free intercorporate dividends.

Before 2015, it was entirely clear that the rule would not apply to the hypothetical distribution described above because (1) none of the purposes of the transaction is to significantly reduce a capital gain on a sale of a share, and (2) the transaction is purely internal to the group and has nothing to do with a third-party sale.

This clarity evaporated on April 21, 2015, when Finance released legislative proposals to amend subsection 55(2). The change was intended to respond to the taxpayer’s win in D & D Livestock (2013 TCC 318), a curious 2013 decision involving a convoluted fact pattern. The remarkable CCH headnote for D & D states that “while the taxpayer’s actions defeated the purpose of subsection 55(2), the Court could not rewrite that section to give effect to its purpose” (Intelliconnect.ca). The Department of Justice seems to have lost the case because it did not plead GAAR (the general anti-avoidance rule). GAAR is supposed to apply when it is clear that an avoidance transaction defeats the underlying purpose of a specific provision.

Although this one-off case posed no real threat to the tax base and could have been reversed through a surgical amendment, Finance decided it had to act forcefully to shut down the structure used by the taxpayer. In doing so, it went beyond merely renovating old subsection 55(2); instead, it levelled the provision and rebuilt it from the ground up. In the process, Finance relegated to the trash bin 35 years’ worth of commentary on the provision—the many helpful administrative policies and assessing practices adopted and publicized to help taxpayers and their advisers better understand subsection 55(2).

For old subsection 55(2) to apply, the core requirement was that one of the purposes of a dividend be to reduce a capital gain on disposition. The new rule is much broader. Crucially, new subsection 55(2) applies whenever one of the purposes of a dividend is to reduce the fair market value (FMV) of a share or to increase the cost amount to the recipient of property (which may include money). The obvious problem here is that almost every dividend has, as one of its effects, the diminution in FMV of the payer’s shares and the increase in the cost amount of the recipient’s property. The amended subsection poses a mind-bending question: When is the purpose of a dividend not to achieve the inevitable effect of a dividend? This difficulty did not go unnoticed by tax professionals, who critiqued the impact these changes would have on tax certainty in everyday situations. Nonetheless, the amendments were enacted in essentially their original form, after some minor tweaks.

This example shows how legislative overreach works and how it can affect tax certainty. Because of the overzealous amendments to subsection 55(2), the movement of cash up the corporate chain is no longer a simple transaction. Now, a real risk exists in some contexts that subsection 55(2) could apply to give rise to a phantom capital gain (amounting to
double taxation) at each level. Given the uncertainty, the CRA has been understandably cautious about providing administrative comfort in this area (though it has made some useful statements about some isolated situations). Tax directors are no doubt being advised to exercise caution.

Other examples of legislative overreach abound, including the following:

- **The restrictive covenant rules.** These rules were first announced in 2003 in reaction to cases that treated non-competition payments as tax-free windfalls. Instead of simply amending section 42 to catch the relevant payments, a complex and often unclear regime was proposed, revised numerous times, and finally enacted many years later, with retroactive effect. In the recent Pangaea case (2020 FCA 21; aff’g 2018 TCC 158), the FCA upheld a CRA assessment applying ordinary income treatment to a payment that had nothing to do with consideration for a covenant not to compete—the original target of the amendments. Following this decision, taxpayers face further uncertainty in the application of this overly broad legislation, which may affect common financing transactions.

- **The expansion of the back-to-back withholding tax rules.** These rules were originally bolted on to the thin capitalization rules but were then expanded into an oddly targeted statutory treaty-shopping or conduit rule with its own web of interlocking, and often unworkable, definitions.

- **The tax on split income (TOSI) rules.** These rules, which affect all sorts of small family businesses, are so complex and contain so many internal definitions that even seasoned tax professionals may have difficulty applying them. Although complexity, on its own, does not necessarily result in uncertainty, the TOSI rules contain numerous vague tests calling for subjective judgments within the context of a byzantine regime.

These examples follow a common pattern. Legislative overreaction gives rise to ill-focused legislation that goes beyond the intended target and produces gratuitous tax uncertainty about common situations. A specific mischief is addressed with the proverbial sledgehammer when a fly swatter would suffice. It is understandable that when Finance acts to shut down a planning opportunity, it wants to avoid creating new opportunities by making the specific measure too narrow. Having said that, greater care should be taken in the future to minimize legislative overreach that diminishes tax certainty.

**Reducing Uncertainty Through Legislative Change**

Finance can play an important role in promoting tax certainty, and sometimes does. One example is the treatment of foreign affiliate distributions. In the past, much energy was spent in determining whether a distribution that has a particular legal character under foreign law would be treated as a dividend or some other type of distribution for Canadian tax purposes. To clarify the issue, Finance introduced subsection 90(2). Effective from 2002, subsection 90(2) essentially classifies all pro rata distributions from foreign affiliates as dividends; this has largely eliminated the previous uncertainty.

Finance has also issued many so-called comfort letters expressing an intention to fix a technical problem with a statutory provision. Although this helpful practice seemed to be on the wane a few years ago, we have seen a recent resurgence. The fact that Finance, with almost no exceptions, has followed through on the recommendations in these letters gives taxpayers strong confidence that its assurances can be relied on.

**The CRA’s Role in Tax Certainty**

The CRA has the unenviable job of administering an increasingly complex system. Because of legislative overreach, taxpayers are increasingly seeking CRA guidance, hoping that overinclusive rules will be administratively limited to the real mischief at which they are targeted. In many cases, the CRA seems reluctant to do this, for fear of being criticized as too soft on the high-income taxpayers that many members of the public believe are undertaxed.

We are seeing greater numbers of ill-informed observers who publicly criticize the CRA for issuing tax rulings, settling cases, or abiding by its longstanding voluntary disclosure program. Social media, with its emphasis on pithy sound bites, makes the situation worse. The resulting political pressures sometimes box the CRA into a corner. The agency fears, with good reason, that if it adopts clear guidelines to limit the application of an anti-avoidance rule, it may be criticized for not insisting that taxpayers pay their so-called fair share. This understandable apprehension limits the CRA’s ability to draw administrative lines when such lines are most needed to address overly broad or confusing legislation.

The CRA must take responsibility, however, for recently changing course, for no good reason, on longstanding pragmatic positions. This seems to be a growing tendency. Of course, the CRA is always entitled to change its position on administrative policy. But when this happens too frequently, taxpayers and their advisers lose faith in the reliability of these policies. This generates greater uncertainty, less predictability, and more disputes.

Consider an example. At the 2018 CTF annual conference’s CRA round table (a forum for senior CRA officials to provide guidance on questions submitted by the tax community), the CRA announced a change to its position on the universal practice of reducing a liquidating subsidiary’s stated capital immediately before the subsidiary is wound up. This common practice, accepted for decades, avoids the potential for the realization of a phantom taxable gain in routine structure-
simplification transactions, which are often necessary for non-tax reasons. Since the CRA’s announcement, taxpayers have been left wondering whether their particular case might be judged abusive by a zealous tax auditor. Unnecessary uncertainty now exists for a previously routine transaction. All of this has occurred in a context where the CRA has failed to clearly articulate its theory of the statutory provision’s underlying rationale.

The CRA’s 2018 about-face was not a one-off event. On December 30, 2019, the CRA cancelled its longstanding information circular on transfer pricing, first published in 1987 and last updated in 1999 (Information Circulars IC 87-2, 1987; and IC 87-2R, 1999). In an unapologetic notice published in February 2020, the CRA explained that the circular is “inconsistent” with its current interpretations, leaving taxpayers to wonder what those new interpretations might be and how exactly they differ from the previous ones. In a departure from the CRA’s 2018 approach, no transition relief was offered to taxpayers that filed their returns on the basis of the CRA’s published policies. This sends the unfortunate message that the CRA’s policies—even published policies that have been in place for decades—cannot be relied on.

This trend is exacerbated by the fact that the CRA no longer publishes interpretation bulletins, which previously set out its policies on a range of topics and were generally understood to be binding. The bulletins were retired many years ago because the government stopped funding them. They are slowly being replaced by income taxfolios. In the meantime, it is often unclear what to make of archived interpretation bulletins.

The problem is compounded by gaps in the rulings process in Canada. Taxpayers in some other jurisdictions have ready access to a responsive, reliable, and predictable rulings process that allows them to obtain from the tax authority a binding ruling on a transaction. As noted above, the IMF/OECD report on tax certainty listed as a key objective the “[a]vailability of a tax ruling function with clear and straightforward rules.” Of course, the CRA has a functioning rulings process, and taxpayers are sometimes able to obtain a helpful ruling on a reasonable timeline. However, most practitioners today do not see a ruling as a viable option for most transactions, which are planned and executed at a rapid pace. Statistics show a declining trend in the number of rulings requested, though this trend may have bottomed out in the past year. The problems with the rulings process are not necessarily all the fault of the CRA, but these problems are a reality, and investing the resources to address them would tend to enhance tax certainty.

Proposals for Future Reforms

The trend away from tax certainty needs to be addressed.

Canada’s federal government should follow the IMF/OECD recommendation and adopt tax certainty as a key objective, distinct from the objective of raising revenue. Tax legislation is currently judged according to several criteria, including anticipated revenues and gender impact. The government should adopt tax certainty as another benchmark in the planning of future reforms.

The government should undertake—perhaps as part of a larger reform of the tax system—to make legislative changes aimed specifically at reducing uncertainty. This will require extensive consultation with the tax community. And, of course, great care will need to be taken not to create still more uncertainty through this process.

An initiative should also be launched within the CRA to determine what measures can be undertaken to foster tax certainty. These might include a rethinking of the rulings process, a rationalization of the huge body of technical interpretations that has built up over the past 20 years, and the formal adoption of a protocol for reversing longstanding administrative positions, especially those codified in official publications. Extensive consultation with the tax community will need to be part of this protocol.

Tax Certainty: An Industry Perspective

Michael Munoz, Suncor Energy

“Certainty” in tax legislation has been a point of discussion among tax professionals for some time. In recent years, these discussions seem to have increased in frequency and emotional charge. From the perspective of a large, public Canadian corporation, the desire for greater certainty in tax matters (and other regulations) has never been stronger. My view is that tax certainty should be a higher priority for legislators than it is.

Lack of certainty can have significant implications for corporate taxpayers and the business environment. It affects investment, directly and significantly; it erodes the ability of business leaders to ascertain and confirm compliance; and it fundamentally erodes the trust between corporate taxpayers and the institutions of government.

Methods of Providing Certainty in Tax Policy

I believe there are three types of tax certainty: substantive certainty, procedural certainty, and situational certainty.

Substantive Certainty

Substantive certainty is what most members of the tax community think about when they hear the term “tax certainty.” Legislation high in substantive certainty seeks to provide understanding. In short, one can read legislation of this kind and intuitively understand what action or inaction is affected and what the related consequences or opportunities are. Drafting styles that favour, for example, quantitative measures, bright-line tests, and safe harbours seek to provide such understanding.
For legislators, the goal of substantive certainty competes with another objective: revenue. Tax policy decisions are weighted heavily toward the fiscal needs of government, and all taxing legislation includes an element of revenue projection. Governments must try to ensure that the rules deliver as intended. This objective is served by the principles of comprehensiveness and intentionality, according to which governments seek to ensure that no “leakage” undermines their policy objectives and that the rules serve their purpose, without exceptions or surprises. Drafting styles that use purpose tests and “reasonability-based” limitations attempt to arm CRA auditors with the discretion and freedom to carry out legislative intentions.

Over the years, I have observed a growing preference, in Canadian drafting style, for comprehensiveness and intentionality over certainty and clarity. Today’s tax legislation tends to be less objective, and purpose tests tend to be used much more frequently than quantifiable tests and safe harbours. Problematically, this trend is based on the assumption that these tests have common, shared meaning. Most people familiar with these interactions would question this assumption. Taxpayers still believe that they are entitled to structure their affairs to reduce tax within the rules, and the CRA believes that it has a duty to recover significant additional revenue through reassessments. Vague and value-based wording is changing some disputes from arguments about the law to contests over values and perspectives. This increases the emotional charge of the dispute and erodes the trust that each institution has in the other.

Procedural Certainty
A tax regime that does not provide substantive certainty can still provide a sufficient level of certainty to taxpayers if it can provide direction: even if you don’t clearly understand how to apply the rules, you know how to come to a resolution. Such direction can be provided in advance, through an effective and efficient rulings system; or afterward, through an effective and efficient dispute resolution process.

Much evidence has come to light in recent years concerning the Canadian system’s struggles in providing procedural certainty (see, for example, the 2018 fall report of the auditor general of Canada). I have found the CRA very reluctant to provide clear and simple direction to taxpayers in all but the clearest of circumstances. I believe that this reluctance is caused by institutionalized fear that taxpayers may confuse, abuse, or expand favourable CRA commentary. As a result, CRA advice, when provided at all, is frequently conservative, tightly restricted by caveats, and inclined toward a conclusion that maximizes tax results in the CRA’s favour. My view is that services such as the advance ruling process have become so burdened by these concerns that they have lost much of their practical utility to businesses.

In addition, the auditor general, along with numerous authors (including myself), has criticized Canada’s tax dispute resolution process for its lack of efficiency and effectiveness. An inefficient dispute resolution system distracts focus from other business concerns and drains corporations’ and the government’s human and financial resources.

The Canadian tax dispute resolution process poses problems for large corporate taxpayers. The rules need better balance. According to the CRA, the imbalance is intentional and necessary, but I have difficulty accepting this view. The legislation includes no substantive requirements that the CRA provide reasons for its reassessments, and the rules allow the CRA to raise new arguments late in the dispute process or in court. By contrast, the legislation limits corporate taxpayers’ ability to raise positions not originally outlined in the initial objection to a reassessment. I have yet to hear a convincing case for this asymmetry, with respect to disclosure rights and obligations, between the CRA and large corporate taxpayers. Furthermore, the CRA is entitled to collect half the amount of the tax assessed upon the initial assertion of an assessment, and it has no time limits on completing an appeal. It is true that if the taxpayer’s position is ultimately sustained, the excess tax collected is returned; however, the interest payable to the taxpayer is at a rate significantly below levels available in capital markets. In short, large amounts of capital are often being levied from taxpayers incorrectly, kept for long periods of time, and returned with low interest. Canadian corporations are thus forced to deploy capital inefficiently.

A more balanced legislative regime is necessary. The regulations could address auditors’ needs to collect information without providing these auditors with an unfettered ability to raise a quantum of additional tax. Taxpayers deserve a substantive and fully formed assessment before being required to pay additional tax. A simpler alternative—if the regulation of reassessment is too complex or untenable a proposition—would be to defer the collection of additional amounts assessed until the close of the appeals process, when the CRA has more fully formed its position. Meanwhile, Canadian corporations would not be forced to deploy capital inefficiently during the long dispute period.

Situational Certainty
A tax system short on substantive and procedural certainty may still provide situational certainty by permission or exception. However, such policies tend to be limited to particular industries, taxpayers, or situations, and are thus inherently political. Common examples include “holidays,” “exemptions,” “incentives,” and “commitments.” The Canadian federal
regime has historically been disinclined to provide situational certainty directly, in the absence of substantive or procedural certainty, preferring instead to prioritize the first two forms of certainty, with greater respect for the rule of law and equality among taxpayers.

**The Impact of Uncertainty**

Tax certainty has significant effects on our business environment. These effects are very difficult to prove, but the signs of a causal link are strong. The consequences set out below reflect my own observations in this regard.

**Investment in Canada and Global Competitiveness**

In most organizations, investment decisions require a compelling narrative to gather support and to overcome risk aversion, general corporate inertia, and bureaucracy. To formulate an investment narrative, organizations prepare financial models incorporating the transparent discussion of assumptions about future costs and opportunities.

Uncertainty impedes the formulation of investment narratives because more and more of the reasoning becomes based on assumptions. And tax and regulatory uncertainty isn’t the only form of uncertainty facing investment decisions. Uncertainty arises from many large, external forces—economic, social, political, and technological, among others. Legislated tax uncertainty is exceedingly frustrating, especially if it is intentional or applicable to only some businesses in certain industries or regions. Global competitiveness clearly concerns the Canadian government. In my view, government can address competitiveness much more easily through concrete metrics, such as tax rates, and tax legislators do not sufficiently appreciate the linkage between uncertainty and investment.

Consider an example from a decade ago, when the global demand for liquefied natural gas (LNG) sharply increased. In 2011, the rapidly rising demand for gas in eastern Asian countries (such as Japan, China, South Korea, and India) rose to a fever pitch when Japan’s Fukushima nuclear power plant was hit by a tsunami and LNG was sought to feed the gas-fired electricity generation that replaced the nuclear energy source. A significant opportunity arose for jurisdictions such as Canada, rich in natural gas feedstock, and with access to waterways to serve these Asian markets. Almost 20 separate projects were undertaken on the Canadian west coast. Other countries, including Qatar, the United States, and Australia, had the same opportunity, and companies were exploring options there as well.

Subsequent events clearly demonstrate the impact that Canada’s substantive tax uncertainty can have on investment decisions. The prospective LNG projects faced many non-tax regulatory hurdles in Canada related to, for example, federal-provincial relations, aboriginal relations, and environmental regulation. Among the tax hurdles, the most significant was whether the 7 percent BC provincial sales tax would apply to construction costs. This tax, unlike a recoverable sales tax such as the federal goods and services tax, would increase the cost of these projects by an absolute 7 percent. The uncertainty over the application of the BC tax dramatically affected the financial models being formulated to help with investment decisions. These financial models were being run without the ability to make a rational case for either building the sales tax in or out of the model. Decisions simply couldn’t be made. Eventually the province, after receiving significant pressure for clarity, publicly advised that the 7 percent tax would indeed apply to these construction costs. The tax results contributed to the conclusion that Canada could not compete with Qatar, the United States, and Australia, and investment shifted sharply. In the decade that followed, eight LNG projects were built in Australia and four in the United States; none were built in Canada. Note that the external world indicators, such as commodity price and global demand, were the same for each country. If the BC legislation had offered certainty, the BC government would have recognized the competitive disadvantage at an early stage and would have had time to consider a legislative or administrative response. The lack of certainty affected the BC government’s ability to make a responsive policy decision.

An interesting update to this story relates to the recently approved LNG Canada project. In an uncommon example of a Canadian government supplying “situational certainty,” the BC government (likely with the benefit of hindsight) has decided to address the investment-chilling concept of a non-recoverable provincial sales tax and has granted a specific sales tax exemption to the LNG Canada project.

**Good Governance and Compliance**

Tax is a regulatory responsibility and administrative obligation. Properly structuring an organization’s affairs to administer and accurately report tax implications is a significant endeavour even for small organizations, let alone for large multinational organizations. In addition, we live in a society where good corporate governance is of great interest to shareholders, governments, and taxpayers. This is a significant reason why organizations are calling for greater certainty in tax legislation. Too often, taxpayers perceive themselves as being fully compliant and conservative, yet find themselves unable to avoid scrutiny and reassessment solely because of the ambiguity of the governing statutes and the procedural gaps in administration.

Tax leaders want not only to be compliant and to mitigate risk, but also to be seen as compliant and as having acted appropriately to mitigate risk. Significant uncertainty in both the legislation and administrative process makes it difficult to distinguish between good and poor corporate governance. When dispute resolution is more closely regulated (so that fewer dis-
Trust and the Rule of Law

A less frequently voiced problem with uncertain legislation is its negative impact on the relationship between taxpayers and government. Legislation that uses bright-line tests and quantifiable measures will result in audit questions targeted at impersonal questions, such as whether the shareholdings were or were not in excess of 10 percent. Contrast this with legislation that is worded with personally critical factors such as whether tax minimization was "one of the main purposes" of a certain transaction. The latter question is not only much more personalized, and potentially accusatory, but also less open to objective proof.

Even with bright-line tests, government and taxpayers can disagree on whether such tests are set appropriately, and taxpayers may not always like the results. But, irrespective of winners and losers, we do not, in my view, have enough of these tests. Canada needs to reduce the volume of tax disputes, and using more of these tests would have that effect. Also, these tests allow tax managers to conclusively ascertain the tax results of proposed activities and confidently explain why the tax is what it is. This is an uncommon luxury today.

Tax legislators and administrators have increasingly shown explicit mistrust of taxpayers. Their communications deploy emotionally charged but loosely defined phrases such as “fair share of tax,” and the CRA audit function has been described in terms of a revenue source, with references to, for example, the “fiscal impact” of audits and to the CRA’s task of “protecting” the fiscal strength of the government. The CRA also uses emotionally charged naming conventions for its employees, such as “abusive tax-avoidance” officers. Corporations’ tax managers and financial representatives, who put significant time and effort into tax compliance, find these characterizations offensive.

I do not want to convey that government’s mistrust is malicious or wholly unfounded. I can understand how government officials can grow frustrated when taxpayers plan around an intended result. I can also see how that frustration could influence future drafting, and how we have ended up here. What I do want to convey, however, is that the response has been excessive, and the pendulum has swung too far in one direction. I believe that GAAR has matured and is now a significant tool that should be paired with clearer legislation to respond to abusive behaviour. The alternative is to continue to under-invest in substantive certainty. This trend has already put a significant strain on the rulings system and the dispute resolution system in Canada, which have not proved efficient enough to provide procedural certainty. This has further eroded trust and hindered the development of productive relationships between government and taxpayers.

Finally, with the recent and projected actions of the Organisation for Economic Co-operation and Development, the taxation of profit earned internationally is becoming uncertain. If the global community follows through with a reconsideration of nexus and how multinational organizations compute and pay tax around the globe, taxpayers are going to experience procedural uncertainty on a whole new scale. With the potential for growing disputes between taxpayers and several jurisdictions that are each exerting rights over the same dollar of tax, I fear that frustrations will grow and undesirable economic implications will follow.

Conclusion

It has been my observation that legislators consistently under-value certainty as a principle in tax policy decisions. The tax administration process has been affected as a result, with increases in delay and cost.

With causation and accurate linking difficult to prove, one can only imagine the additional capital that would have been injected into the Canadian economy had certainty been a greater focus in our regulatory and tax landscape. I believe the missed opportunity to be significant. In addition, compliance with tax laws has become a global concern for governments, but the lack of certainty has made it almost impossible to prove (or disprove) compliance without entering the dispute resolution process, which has put unsustainable pressure on this process. This state of affairs has eroded the institutional trust between government and taxpayer.

As the speed of business and communication accelerates, the ability to clearly determine the applicability of laws simply from their wording is needed now more than ever. Business leaders need to know what the rules are and how to get their questions answered, and, if they have a dispute, they should expect to be treated fairly and justly within a reasonable amount of time. Governments and taxpayers need once again to be able to trust each other’s systems and institutions, and this can start only through the elevation of certainty as a priority in tax and regulatory policy.
Tax Certainty and Canadian Business Investment: Recent Academic Research

Kenneth J. Klassen, KPMG Professor of Taxation, University of Waterloo

It is commonly understood that businesses and markets dislike uncertainty. But does the uncertainty within the tax system have an observable effect on the value of Canadian businesses in the global economy? This is an important question: if the Canadian tax system decreases the value of Canadian businesses, the country becomes a less desirable place to invest, and corporations will face a higher cost of capital.

A Recent Study of Transfer-Pricing Uncertainty

To begin to understand the valuation impact of transfer-pricing uncertainty, Devan Mescall and I studied mergers and acquisitions (M & A) and published our findings in a 2018 article, “How Does Transfer Pricing Risk Affect Premiums in Cross-Border Mergers and Acquisitions?” (Contemporary Accounting Research). The analysis included more than 3,100 cross-border M & A transactions among 39 countries over the period 2000 to 2012. For assessing firm value, there are several benefits to studying M & A transactions rather than, say, stock market prices. First, the M & A transaction is usually large and subject to detailed analysis by the acquiror through the due diligence process, making the transaction value a reliable estimate of firm value. Second, and importantly for this context, the M & A transaction can identify specific characteristics of the target and the acquiror, characteristics that form a basis for comparison across firms and in different countries. Finally, well-established methods make it possible to control for differences in transactions, making the inferences from the research more reliable.

One notable drawback of this research is that the M & A transactions sampled involved public companies acquiring public companies. It is not possible to compute the acquisition premium of a private target because the value of the private company before the M & A announcement is not reliably known. Although the valuation effects of the transfer-pricing uncertainty on private companies may be conceptually quite different, the same economic forces apply. The magnitude of the effects for private companies may be greater or less than for public companies, depending on how uncertainty would affect the pre-merger private target.

To explore the tax uncertainty that arises from transfer-pricing rules and enforcement, the research for our study relied on an extensive survey of 76 transfer-pricing experts from 33 countries and 2 global accounting firms, including 8 experts from Canada. The 45 partners and 31 managers surveyed gave 448 detailed assessments of the transfer-pricing uncertainty (or “transfer-pricing risk”), which were based on first-hand experience with tax authorities in those 33 countries. These assessments formed the basis of a measure of transfer-pricing uncertainty over time and across countries.

On the basis of these data, Canada consistently ranked very high in transfer-pricing uncertainty. In the survey, Canada ranked fifth-highest, behind India, Brazil, the United States, and Germany. When the multi-year estimation approach was employed, Canada ranked among the top five throughout our sample period. Although the method used to extrapolate the ranking across time has some limitations, it is clear that Canada is consistently among the most uncertain countries when it comes to the tax treatment of international transfer prices. The recent cancellation of the longstanding Information Circular IC87-2R, “International Transfer Pricing,” continues to add to transfer-pricing uncertainty in Canada.

So, what is the effect of uncertainty on the countries’ businesses? Using a variety of specifications, the analyses show that an increase in transfer-pricing uncertainty reduces the M & A premium that acquirors are willing to pay, on average, across the multinational sample. The results of the statistical model are consistently reliable at a high level. The effect is quite large. For example, if a country reduces its transfer-pricing practices percentile rank by 0.3, the increase in M & A premium is 2.3 percent. The decrease in percentile rank of 0.3 would, for example, take Canada from its rank of fifth-highest to the average rank for the 39 countries. (Countries with an approximately average rank include Argentina, Denmark, the Netherlands, and Spain.) Overall, given that the M & A premium in our sample has a median value of 22.2 percent, such a change would increase the premium to 24.5 percent, which suggests that the overall market value of firms is 2.3 percent lower than in countries with less transfer-pricing uncertainty.

Our study also explores acquisitions in which transfer pricing is expected to be more important. For example, if the acquiror and the target are in the same two-digit standard industrial classification (SIC) industry code, the acquiror and the target are likely to engage in more intercompany transfers in the future. For this subset of M & A transactions, the effect of transfer-pricing uncertainty almost doubles. That is, the effect of a 0.3 decrease in percentile rank increases to 3.9 percent of value. If the acquiror and target firms are both in high-technology industries, the results imply that the average valuation increase would be 4.3 percent.

Overall, the study provides strong evidence that the uncertainty in international transfer pricing reduces the value of Canadian corporations in the international marketplace. A lower value has negative consequences for the firm, even in the absence of a potential acquisition. For example, lower firm values raise the cost of capital, reducing firms’ abilities to invest and grow.
Two Studies on Tax Uncertainty and Firms’ Investment Decisions

Other scholars have studied the effects of tax uncertainty on firms’ internal investment decisions. A 2017 study by Michelle Hanlon, Edward Maydew, and Daniel Saavedra (“The Taxman Cometh: Does Tax Uncertainty Affect Corporate Cash Holdings?” *The Review of Accounting Studies*) explores the effects of tax uncertainty on firms’ propensity to hold cash. The authors theorize that firms that are subject to greater tax uncertainties will hold additional cash as a precaution against negative tax outcomes.

To measure tax uncertainty, the authors use the financial reporting disclosure of unrecognized tax benefits (UTBs) required under US generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS). Other scholars have demonstrated that a firm’s UTB amounts are strongly related to its engaging in business transactions with greater tax uncertainty, such as R & D and transfer pricing, and to its using more aggressive tax plans.

Using a sample of US public companies, the authors examine the relation between cash holdings and the size of UTBs, controlling for a variety of drivers of cash holdings, including a broad measure of tax-planning aggressiveness. The results of the study show a strong positive relation between the two, which is consistent with the proposition that greater tax uncertainty leads to greater cash holdings. The relation is found in both domestic and multinational US corporations, with a stronger relation for domestic corporations. Additional tests show that the relation is stronger among financially constrained firms that would have less ability to access additional capital should the need arise.

A 2019 paper by Martin Jacob, Kelly Wentland, and Scott Wentland (“Real Effects of Tax Uncertainty: Evidence from Firm Capital Investments”) explores the capital investments of firms. This paper uses the IRS’s staggered introduction of the Schedule UTP—a form for reporting uncertain tax positions (UTPs)—between 2010 and 2014. The Schedule UTP required firms to provide the IRS with additional disclosures regarding their UTB amounts. This new requirement increased uncertainty about enforcement because firms believed that the IRS would use this new information in its audit efforts.

Because the introduction of new disclosure requirements increased the uncertainty of future tax enforcement without a change to tax-planning activities, this analysis focuses on tax authorities’ introduction of changes to tax-payment uncertainty. Using a typical sample of companies, the authors show that greater tax uncertainty is related to different types of, or more aggressive, tax planning. In such a sample, it is difficult to disentangle the effects of the tax plans from the effects of uncertainty about enforcement. Under this paper’s approach, inferences can be drawn by holding constant the corporate actions while changing the tax uncertainty through the IRS requirement implementation alone. Using this approach, the authors demonstrate that the tax uncertainty created by this new reporting regime caused firms to delay large capital investments and to lower the overall level of investment on productive assets. The authors also use the UTB amounts, as in the study by Hanlon et al.

Overall, these two studies demonstrate that greater uncertainty about tax liabilities causes companies to reduce and delay capital investment in order to hold more cash against the possibility of future tax payments. In the case of the study by Jacob et al., the change in investment strategy is related not to aggressive choices by the firm but to additional tax reporting, which was perceived to create greater uncertainty regarding future IRS enforcement.

Implications for the Canadian Tax System

The academic research reviewed above highlights several implications of greater tax uncertainty. The first paper, using the narrow focus of transfer-pricing regulation and enforcement, demonstrates that the value of Canadian corporations is adversely affected by high levels of tax enforcement. The effect of reduction in firm value is likely to hold more broadly, since various forms of tax uncertainty impose similar costs on the corporation. Lower firm values mean greater difficulty in raising capital, and less investment. The second and third papers discussed above show that firms facing higher levels of tax uncertainty will shift investment from the acquiring of more productive assets to the holding of cash as a precaution against future tax assessments. In sum, these findings suggest that Canadian investment would be enhanced by greater certainty in the tax system.

Tax Certainty, Legislative Complexity, and Safe Harbours

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Tax certainty and legislative complexity are related concepts, but one does not always drive the other (or, at least, not in the same direction). That is, uncertainty in a particular area of Canadian income tax can (and arguably does) arise either from legislation that is very simple or from legislation that is very complicated. Conversely, simple measures can help to reduce uncertainty, as can additional complexity when it is employed to better target a particular tax concern. Recent tax legislation has tended, however, to introduce both more uncertainty and more complexity. Our tax system and Canadian taxpayers deserve a stronger dose of certainty.
Dispositions of Property: Capital Gain or Ordinary Income?

For example, one of the most basic questions in Canadian income tax is whether a gain from a particular disposition of property is a capital gain or ordinary income. The related legislation is, in a sense, simple because there are no legislative rules of general application that answer the question. Courts have, therefore, been required to develop common-law rules, in the form of general factors and considerations, that can be applied to a taxpayer’s particular situation. Although these rules are now reasonably well understood by tax professionals, significant uncertainty remains in applying them to actual fact patterns (especially in a planning context, because uncertainty regarding future events or a taxpayer’s actions and decisions can affect the determination). Some legislative action has been taken to reduce this uncertainty—specifically, the “Canadian securities” election in subsection 39(4), which allows a taxpayer who is not a “trader or dealer in securities” to elect guaranteed capital treatment on all dispositions of Canadian securities. Of course, some uncertainty remains, because it is not always clear who is a “trader or dealer.”

More recently, other, less straightforward legislative action was taken with the enactment of the “derivative forward agreement” (DFA) rules, which are intended to ensure that amounts that should receive regular income treatment are not artificially converted into capital gains. The Canadian securities election is a “safe harbour” approach that reduces both complexity and uncertainty, improving the overall predictability of outcomes. The DFA rules, in contrast, add both uncertainty and complexity. Appropriate safe harbours (or, more generally, bright-line tests as to when a provision does or does not apply) can play a significant role in reducing uncertainty and complexity for both taxpayers and the government, and should therefore be encouraged.

In the context of gains from real estate investments, the uncertainty can be even more severe, given the case law concept of “secondary intention.” It can be particularly difficult to properly advise prospective investors in an income-producing property as to whether the tax component of their underwriting model should reflect capital gain or income treatment on exit at the end of the modelling period. Even if there are no concrete plans to resell the property at the end of the period (such that the “exit” is only notional), will the model’s assumptions regarding end-of-period values be used as evidence of the investor’s motivation in making the investment?

If the investor is skilled at improving operating efficiencies and tenant mix and, as a result, is able to forecast improvements in future net rental income that drives an assumed end-of-period gain, will that taint the character of a gain that is ultimately realized? Private real estate investment funds—in particular, inbound funds that often need to employ a taxable blocker entity within the fund structure to avoid imposing Canadian tax-filing obligations on ultimate investors—find it very difficult to tolerate this tax uncertainty, both as it affects the initial investment decision and (more importantly) at the time of a distribution to investors following a property disposition, when appropriate holdbacks for tax liabilities must be determined. Lengthy and costly disputes (for both taxpayers and the government) are becoming more common, and this situation can only be expected to worsen.

A “minimum holding period” election for real property interests that would guarantee capital property treatment, for a taxpayer that is not a trader or dealer, could eliminate many such disputes and allow CRA resources to be redirected. For example, the owner of such an interest could be allowed to make a “capital property” election in respect of a particular property for the year in which the property becomes available for use (as defined, in subsection 11(28), for depreciable property that is an interest in a building). The election would deem the interest to be capital property for the purposes of characterizing a gain or loss on a subsequent disposition of the property that occurs at least one calendar year after the end of the year for which the election is made. Rules for non-arm’s-length transfers could recognize the holding period (and previous elections) of the transferor. In the absence of an election, the existing concepts would continue to apply.

Although this kind of safe-harbour rule could instead apply automatically on the basis of a minimum ownership period, having to make an initial election could prevent a taxpayer from attempting to take advantage of “guaranteed” capital treatment if a gain results while keeping open the option of arguing income treatment (on the basis that the taxpayer is a trader or dealer) if a loss arises on a disposition after the minimum hold period. Finally, the rule might also extend to characterize as capital property (for greater certainty) equity and debt interests in an entity that has made the election and that meets the minimum holding period.

Uncertainties in Applying the TOSI Rules

Safe harbours, however, can sometimes amount to a band-aid approach to a more serious problem of legislative uncertainty. The recent expansion of the tax on split income (TOSI) rules in section 120.4 is a good example. The rules now operate on the premise that everything is caught within the definition of “split income,” unless a specific exception can be found in the definition of “excluded amount.” Most taxpayers are forced to determine whether a particular amount can be considered to be derived directly or indirectly from a particular corporate, partnership, or trust business or investment activity (a challenging and subjective exercise, riddled with uncertainty), or whether the amount meets a very imprecise “reasonableness” test. A number of bright-line safe harbours are provided, but...
access to one useful carveout, which is based on whether a minimum shareholding threshold is met, may be greatly narrowed depending on the underlying corporate activity and structure; as a result, many situations that would otherwise appear worthy of relief may be excluded from the safe harbour.

The underlying problem with the TOSI rules is arguably the legislative approach that requires the taxpayer to find, and be able to support, an exception to the rules, rather than requiring Parliament to better define those situations targeted by the measure. The resulting uncertainty is often proving difficult for taxpayers and their advisers to resolve because it is difficult to discern a coherent scheme or principle regarding the precise tax mischief that the rules are attempting to police.

Because the TOSI rules are both complex and uncertain in their application, and because they are, in general, most relevant to a “mid-range” level of taxpayer that does not have the resources to devote to the thorough analysis that greater certainty would require, the practical approach for a taxpayer tends to be to argue that the rules simply "shouldn't apply" and to hope that the CRA will not conduct wide-ranging audits in this area. Clearly, this is not an ideal approach in the context of a self-assessment tax system, and, more broadly, it does not help to foster confidence in the Canadian tax regime.

This approach is becoming more common, however, as taxpayers respond to the tendency of recent tax legislation to favour additional complexity in an attempt to improve the government’s certainty that perceived avoidance will be curbed. The complexity arises because the rules are attempting to combat not just the specifically identified avoidance problem but also all possible variations of, or extensions to, that problem. It seems that a robust analysis has not always been applied to determine whether the benefit to the government (for example, increased revenue or reduced tax leakage, net of additional collection costs) and the tax system (for example, a public perception of “fairness”) justifies the cost to taxpayers (in terms of both compliance costs and potential additional tax). Notable examples of this legislative shortcoming, in addition to the TOSI amendments and the DFA rules mentioned above, include (1) the expanded “back-to-back” rules for corporate loans to shareholders, (2) the “specified corporate income” rules that can limit the available small business deduction, and (3) the modified rules in subsection 55(2).

**The Uncertain Scope of Subsection 55(2)**

Given the significantly adverse impact of the application of some of these provisions, taxpayers can’t always afford to simply wish away the problems posed. Extra time and cost may be required to structure a business transaction in such a way that an expansive anti-avoidance rule won’t apply to it, even where the taxpayer has no real intention of avoiding tax. A recent taxpayer situation illustrates one such problem, in the context of subsection 55(2).

Opco was owned by a corporation (Aco) and an individual (Mr. X). Each owned 50 percent of the single class of common shares that were outstanding. Opco carried on a business as a going concern and had safe income on hand attributable to both of the shareholders. Mr. X sold his 50 percent common share interest to an unrelated corporation (Bco). Following the sale, Bco and Aco were able to refinance the operations of Opco and otherwise free up some cash for distribution. Aco’s share of this was well within the safe income attributable to its shares. Bco’s shares had no safe income, because they had just been acquired at fair market value (FMV), such that they had no accrued gain (all of the safe income previously attributable to these shares was now incorporated in the adjusted cost base of the shares to Bco).

Opco might have simply distributed the cash by way of a taxable dividend on its common shares, but Bco was concerned that one of the purposes of the payment or receipt of the dividend might be considered to be to effect a significant reduction in the FMV of the share (or a significant increase in the cost of property), such that subsection 55(2) might apply in respect of Bco’s share of the dividend by virtue of subparagraph 55(2.1)(b)(ii)). Arguably, no such “adverse” purpose existed, but it would be very difficult to eliminate any uncertainty in this regard, and the consequences of being wrong (tax payable by Bco where no economic gain had been realized) would be severe.

In theory, the expanded purpose tests in subsection 55(2.1) suggest that Opco should instead make a distribution to Bco that would reduce the tax cost of its shares, such that Bco would not be able to take advantage of having shares with a tax cost in excess of FMV. Unfortunately, subsection 55(2), unlike rules in the foreign affiliate context, was not designed with a feature that simply allows the shareholder to treat a dividend as a return of capital resulting in a tax basis reduction. Instead, Bco must choose whether to risk being judged as having an improper intention with respect to the dividend, an intention that could be very difficult for Bco to disprove.

Given the Opco share structure, there was no easy way to distribute to Bco as a cost basis reduction while at the same time allowing Aco to receive its share of the distribution as a safe-income dividend. Instead, a complicated share restructuring and further series of steps were required so that the shareholders could receive their respective shares of the distribution in a manner that would be satisfactory for each in the context of subsection 55(2) and would not alter their intended 50 percent ongoing interest in Opco.

The uncertainty introduced into subsection 55(2) by the expanded purpose tests, with no guidance on whether a specific avoidance context should be linked to those purposes for
the subsection to apply, is but one of a number of ways in which the 2016 amendments increased the uncertainty about the application of subsection 55(2). Although the government has a legitimate concern to constrain the inappropriate use of tax-free intercorporate dividends, more work on this subsection is needed to find a more reasonable balance.

Tax uncertainty can never be eliminated; our world is too complicated, and no properly functioning tax system can ever fully and comprehensively address all possible situations and fact patterns. Nevertheless, when Canadian income tax legislation is being evaluated, more regard should be given to increasing tax certainty and reducing tax uncertainty, and to whether proposed tax measures are capable of reasonable application by both taxpayers and the CRA.

### Tax Uncertainty: Abusive Tax Avoidance and Aggressive Tax Planning

**Kevin Kelly, Ontario Ministry of Finance, Legal Services Branch, Senior Counsel, Tax Avoidance Analysis Unit**

(All views expressed are solely his personal views.)

Whether we are tax planners, legislative drafters, tax administrators, tax policy advisers, or tax litigators, we accept a level of uncertainty in determining how tax legislation, tax treaties, and judicial doctrines apply to different transactions. Analyzing complex tax rules and sophisticated legal arrangements amid this uncertainty is what develops our creative analytical and advocacy skills. As tax experts, we see different shades of grey where others see black and white. Although we may thrive on this uncertainty, our clients (taxpayers and government) do not.

Although the term “tax avoidance” is often used pejoratively, I consider “tax planning” and “tax avoidance” to have the same meaning: arranging one’s affairs to minimize tax (“tax minimization”). In this article, I use the two terms interchangeably to discuss the uncertainty about whether tax planning that is specifically designed to achieve a tax benefit is acceptable, or unacceptable, tax avoidance.

I accept that tax legislation may not clearly articulate where these lines are drawn. Legislative certainty, predictability, clarity, and simplicity (while obviously laudable objectives) can be difficult to achieve with tax legislation that is intended to apply to complex and evolving multijurisdictional legal arrangements, particularly when potentially unacceptable tax-avoidance transactions are also being considered. If we accept some legislative uncertainty (that is, accept that there will be different and contrary interpretations of tax legislation), how can we then address the concerns of both government and taxpayers when each considers potentially unacceptable tax planning in the context of this uncertainty? The government has limited awareness or understanding of the types and scope of specific tax-avoidance transactions it may want to address, and taxpayers have a limited ability to predict whether, when, and how the government may address such transactions. And the calculus used in deciding to implement the transactions may have changed by the time the transactions are addressed.

### Abusive Tax Avoidance and Aggressive Tax Planning

Abusive tax avoidance is tax planning that “does not work.” A court determines that the planning engaged in by the taxpayer was illegal and that any challenge by the CRA will be upheld. This determination may be based on a specific anti-avoidance rule, a judicial doctrine, or GAAR. The courts are the final arbiters of whether tax planning is abusive tax avoidance. The CRA is the gatekeeper of this determination.

Aggressive tax planning is planning that “works” in the sense that a court determines that the planning engaged in by the taxpayer was legal and not abusive tax avoidance. However, if Finance determines the outcome of the planning to be contrary to its tax policy considerations, it will address the planning through legislative amendments designed to protect the integrity of the tax base. Finance is the final arbiter in determining whether tax planning is aggressive.

There is obvious overlap between abusive tax avoidance and aggressive tax planning. The distinction between the two is merely an attempt to differentiate the types of tax avoidance generally of concern to the CRA (administrative) and Finance (legislative).

### Considering Potentially Abusive or Aggressive Tax Planning

From a taxpayer’s perspective, uncertainty about the tax consequences of a potentially abusive or aggressive tax-avoidance transaction becomes a consideration when the costs and benefits (and pricing) of the transaction are being determined, before a decision is made to implement the transaction. In this process, taxpayers generally consider (1) their adviser’s tax advice and opinion; (2) whether and when the CRA or Finance may become aware of the transaction and, if they become aware of it, whether the CRA may challenge the transaction as abusive or Finance may address it as aggressive; and (3) any reputational risk that may arise if the taxpayer is alleged to have engaged in abusive or aggressive tax avoidance. Taxpayers also consider the cost of the planning and implementation, the interest on any potentially reassessed tax, the cost of resolving or litigating any dispute with the CRA, and whether a provision for uncertain tax positions will be required in any audited financial statements. If a taxpayer determines that the expected tax benefits outweigh the expected costs of the potentially abusive or aggressive tax-avoidance transaction,
it will proceed with the transaction, and adverse consequences will subsequently arise only if its expectations and calculus (as reflected in the pricing) prove wrong.

From the government’s perspective, public finances are estimated on the basis of economic models that assume the integrity of revenue expectations that result from tax legislation after taxpayer responses are accounted for. The government’s ability to predict tax-planning responses is limited, however. If the expectations are not met (owing to tax avoidance that the government did not anticipate and is not aware of), the tax base is eroded. Base erosion can lead to increased public debt, increased tax rates, a broadening of the tax base, or decreased public services. These consequences affect all taxpayers, not just those who have engaged in the potentially abusive or aggressive tax avoidance.

Tax Opinions: Limitations

Tax is complicated. That is why we tax experts are asked to do what we do. We advise clients (taxpayers or government) on the consequences likely to follow from the application of tax legislation, tax treaties, and judicial decisions to legal relations and transactions. Our advice is based on our considered opinion, and one adviser’s considered opinion may be different from another’s. Prudent clients may seek more than one adviser’s opinion.

A tax opinion is not confirmation that a tax-avoidance transaction “works” or “does not work.” A tax opinion is merely a person’s or firm’s opinion. Tax advisers must ensure that clients (whether taxpayers or government) understand the limitations of the advisers’ tax opinions and advice in any relevant risk assessment. A tax opinion is generally limited by (1) whether or not it is a legal opinion; (2) the relevant experience of the adviser; (3) whether the adviser has any bias or conflict of interest; (4) the facts outlined and assumptions made; (5) the opinion level (“better view” or “more likely than not,” “should” or “will”); and (6) the inevitably static nature of an opinion (that is, an opinion does not consider potential changes or trends in judicial decisions, administrative positions, legislation, international developments, or public sentiment).

Tax opinions are not insurance against tax uncertainty. Transactional tax-risk insurance (alternatively, tax-liability or tax-opinion insurance) is commercially available to taxpayers precisely for this purpose. However, a tax-avoidance transaction for which the tax-opinion level is less than a “should” may be an uninsurable risk.

Taxpayers should consider the value (if any) of a “better view” or “more likely than not” opinion in their cost-benefit analysis for any tax-avoidance transaction. Any taxpayer proceeding with a “better view” or “more likely than not” opinion has obviously decided to accept tax uncertainty. A voluntary tax rulings process is available to provide certainty to taxpayers.

Transparency

There is little transparency between the government and taxpayers. The relationship is generally adversarial rather than collaborative. This lack of transparency and cooperation results in considerable uncertainty about whether the government is aware of tax-avoidance transactions, let alone whether it considers a particular case of tax planning to be abusive or aggressive. That is why taxpayers cannot predict whether, when, or how the government may address a particular transaction.

Are there voluntary arrangements, in addition to the tax rulings process, that may encourage transparency, cooperation, and tax certainty? In the UK tax-avoidance context, the Code of Practice on Taxation for Banks, which has existed since 2009, is an example of an apparently successful voluntary arrangement between an industry group and HM Revenue & Customs. The approximately 320 voluntary participants include the six largest Canadian banks.

If voluntary disclosure and cooperation do not help to increase transparency, should taxpayers be required to proactively disclose potentially abusive or aggressive tax-avoidance transactions in a timely manner? Canada has quite limited mandatory disclosure requirements compared with the robust requirements for tax-avoidance transactions in the United States, the United Kingdom, and the European Union.

Changing the Calculus

Tax uncertainty is merely one variable in a taxpayer’s calculus in deciding whether to implement a potentially abusive or aggressive tax-avoidance transaction. The cost to a taxpayer of this tax uncertainty does not necessarily outweigh the benefits of entering into the transaction. Could increasing the expected costs have a material effect on how taxpayers manage the calculus for this tax uncertainty?

What if the CRA and Finance were made aware of, and were able to consider and address, potentially abusive or aggressive tax-avoidance transactions in a more efficient and timely manner, through enhanced regimes for voluntary or mandatory taxpayer disclosure? What if there were a monetary penalty for taxpayers that are found to have engaged in abusive tax avoidance? What if there were increased public, regulatory, or investor scrutiny of abusive or aggressive tax avoidance as an ESG (environmental, social, or governance) factor?

Could such changes—if we accept that some uncertainty is inevitably involved in determining whether tax planning is acceptable or unacceptable tax avoidance—make taxpayers less inclined to engage in or facilitate potentially abusive tax avoidance or aggressive tax planning? The implementation of fewer potentially abusive or aggressive tax-avoidance transactions is one obvious way to better manage the adverse consequences of the uncertainty for both taxpayers and government.

Perspectives on Tax Law & Policy

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A Litigator’s Perspective on Tax Certainty

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Imagine yourself in a sunny boardroom closing a big, important deal. You are reasonably confident in the tax analysis. You have a legal opinion from your tax lawyer.

Now imagine yourself pulling open the doors of a courtroom at the Tax Court of Canada. It is about 10 years later. As you approach the witness stand to testify, how confident are you now?

In this article, I focus on some issues that affect tax certainty at the litigation stage. Courts strive to follow Parliament’s intent, and to resolve disputes by using objective legal principles rather than subjective impressions. These efforts foster consistency, predictability, and fairness in tax law. Uncertainty can nevertheless creep in.

Tax Law Is Not Interpreted in a Vacuum

Some tax opinions approach tax law in an abstract, clinical way. Courts rarely do. During a trial, submissions on tax law come last. By this point, the trial judge has heard testimony from fact and expert witnesses, if any, and has admitted the entire evidentiary record. The evidence therefore contextualizes the legal arguments. The same is true on appeal, where the justices may access the evidentiary record, written submissions, and authorities before the hearing begins.

Certainty of the Issues

Will the issues considered by the court be the same as the issues covered in the tax opinion? The list will likely be shorter, and it may be different.

The tax authority may take issue with only particular positions in the tax opinion. However, the issues in dispute can change before trial. The Crown may not argue that the basis of an assessment is incorrect, but it may abandon the original basis and advance alternative arguments. For example, in Burlington Resources Finance Company v. The Queen (2020 TCC 32), the Tax Court allowed the Crown to abandon transfer-pricing allegations that it had pursued for seven years through contentious discoveries and multiple pretrial motions.

Once a trial is under way, uncertainty arises about whether the court will accept the issues as framed by the parties. There exists a debate concerning the judge’s role in a tax appeal. One view is that the trial judge must scrutinize whether the assessment under appeal is correct, and do no more than that. As Justice Rothstein explained in Canada v. McLarty (2008 SCC 26), “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 [s]he chooses to assess, is right or wrong.”

Another view is that the judge’s role is to determine the correct tax analysis. This view underpinned the Tax Court decision in Descarries v. The Queen (2014 TCC 75). The appeal involved GAAR. The Tax Court directed submissions on whether a particular provision had been misused or abused, departing from the basis of assessment and the parties’ positions and introducing uncertainty into the issues.

Certainty of the Outcome in Technical Tax Cases

Will the court resolve technical tax issues in the same way as the tax opinion? Possibly not, for a variety of reasons, including (1) evidentiary issues, (2) the court’s approach to statutory interpretation, and (3) after-the-fact changes in law and extrinsic aids.

Evidence

Tax opinions often assume facts. In tax litigation, facts must be demonstrated with admissible evidence on a balance of probabilities. Taxpayers also bear the onus of disproving factual assumptions made by the tax authority. A taxpayer may have a good legal theory but lose through failure to adduce sufficient evidence.

Statutory Interpretation

The court’s approach to interpreting a tax statute may affect the outcome of a case. The Supreme Court has endorsed the modern approach: a textual, contextual, and purposive analysis. Another strand of case law endorses an approach that seeks a sensible, practical, and commonsense result that is consonant with the legislative scheme.

Recently, in Canada v. Cheema (2018 FCA 45), the Federal Court of Appeal confronted the tension between these two approaches. The question was whether a supply under a new housing rebate regime was made to a person signing an agreement of purchase and sale (as the majority held) or to a person obtaining beneficial ownership (as the dissent would have held).

The majority in Cheema explained that the “sensible, practical and common sense” analysis was unsupported by authority and intolerably subjective compared with the modern approach: “[T]he latter turns on the nature of the legislation while the former depends on the nature of the judge. One judge may think a result is sensible, practical and in accordance with common sense; another may say it is nothing of the sort.”

According to the majority, the approach to statutory interpretation made all the difference: under one approach, the taxpayer lost; under the other, the taxpayer would have won.

After-the-Fact Changes in Law

After-the-fact changes in tax law are especially vexing. The court must apply tax law that applies to the relevant taxation year at the time of the decision. The constitution does not bar
retroactive changes in tax law. By passing a retroactive amendment while litigation is ongoing, governments sometimes “win” a case (for example, Procter & Gamble Inc. v. Ontario (Finance), 2010 ONCA 149) or bolster a position in an ongoing case (for example, CIBC v. The Queen, 2006 TCC 336).

Many legislative amendments are not retroactive to the period under appeal. The general rule is that an amendment does not mean that the amended law is different from the pre-amendment law, or that the amendment involves any declaration as to the previous state of the law (see, for example, section 45 of the Interpretation Act).

The debate is about whether the consideration of subsequent amendments is too subjective. The trial and appeal decisions in Silicon Graphics Ltd. v. Canada (2002 FCA 260; rev’g 2001 CanLII 689 (TCC)) illustrate the point. The Tax Court refused to consider subsequent amendments because different people could come to opposite conclusions about their effect: “One person might draw the inference that Parliament was merely making explicit what was always implicit. Another might conclude that Parliament was seeking to correct deficiencies in the prior legislation. Another might conclude that Parliament was intending to change the law.” These uncertainties made subsequent legislation a “wholly unreliable guide” to interpretation.

On appeal, however, the Federal Court of Appeal considered objective legal principles rather than subjectivity to be involved: “[T]he Interpretation Act does not preclude the Court from drawing an inference that amendments to legislation are intended to change the legislation where the internal and external evidence warrants such a conclusion.”

The result is that a court may scrutinize a transaction by reference to legislative amendments not yet made, or even proposed, when the transaction closed. The tax opinion would simply not have addressed such matters.

After-the-Fact Changes in Extrinsic Aids

Courts may consult extrinsic aids in interpreting legislation. Uncertainty arises when courts consider extrinsic aids that were published after the transactions at issue occurred. Materials published by the Organisation for Economic Co-operation and Development (OECD) provide an illustration. Views change on whether particular international tax plans are acceptable, and how certain analyses should be performed. Certainty is compromised if attitudes change between the closing of the deal and the tax appeal.

The narrow debate is about which version of various publications to consult. For example, the courts have recognized the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“the OECD guidelines”) as permissible extrinsic aids in transfer-pricing cases. Several versions have been published since 1979. Courts have considered versions published after the period under appeal. In a transfer-pricing case that applied former subsection 69(2) of the Income Tax Act to the 1990-1993 taxation years of GlaxoSmithKline Inc., the Supreme Court considered both the 1979 and 1995 versions (Canada v. GlaxoSmithKline Inc., 2012 SCC 52).

Similarly, courts have accepted the OECD Model Tax Convention on Income and Capital with Commentaries as a permissible extrinsic aid in the interpretation of Canada’s bilateral tax treaties. Many versions have been published since 1977. The leading case regarding which version to consult is Canada v. Prévost Car Inc. (2009 FCA 57). The case involved a tax convention first concluded in 1986, and dividends paid between 1996 and 2001. The Federal Court of Appeal held that the 2003 commentaries were the version to consult.

A court may interpret Canadian tax law and treaty provisions by using extrinsic aids that did not exist when the transaction closed and that may depart from the norms that existed at that time. In some cases, the tax opinion could not reasonably have anticipated such developments.

Certainty of the Outcome in Anti-Avoidance Cases

GAAR is sometimes considered an affront to the customary pursuit of certainty, predictability, and fairness in tax matters. Will a court analyze GAAR in the same manner as the tax opinion does, assuming that the opinion dealt with GAAR? Maybe not.

Often the greatest uncertainty in GAAR cases is whether a court will decide that granting a tax benefit fulfills or defeats the object, spirit, and purpose of the provision giving rise to the tax benefit. The debate is whether GAAR is a “judicial smell test” or a rigorous legal standard.

The Supreme Court has clarified that the Crown bears the onus of demonstrating the object, spirit, and purpose of a provision and any misuse or abuse, and the benefit of any doubt goes to the taxpayer. The Supreme Court cautioned in Copthorne Holdings Ltd. v. Canada (2011 SCC 63) that “determining the rationale of the relevant provisions of the Act should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do.” Rather, the case law supports using the modern approach to statutory interpretation in determining the object, spirit, and purpose of a provision: a textual, contextual, and purposive analysis. Nonetheless, concerns about subjectivity arise whenever a GAAR decision is reversed because of a different view of a provision’s object, spirit, and purpose.

Subsequent legislative amendments are especially challenging in GAAR cases. GAAR is sometimes applied to periods that preceded a legislative amendment, as if the amended text captures a continuing object, spirit, and purpose. This strategy succeeds or fails depending on the court’s interpretation of the amendment. The Federal Court of Appeal explained in
Canada v. Oxford Properties Group Inc. (2018 FCA 30) that “the provisions used to obtain the tax benefit must first be construed on their own. Only then can one say whether a subsequent amendment that touches upon the same subject matter confirms or alters the prior state of the law” from a GAAR perspective.

Conclusion
The best defence against uncertainty in tax litigation is admissible evidence of important facts. In this article, I have suggested that events that occur after the fact and, generally, beyond a taxpayer’s control may influence the outcome of litigation in technical and anti-avoidance cases. Uncertainty may result; on the other hand, subsequent developments may support positions taken in the opinion. A skilled tax litigator will develop a theory of the case that accounts for these variables, and for many others, in preparing the best possible appeal.

Tax Certainty: Views from a Tax Official
Ted Gallivan, Assistant Commissioner, International, Large Business and Investigations Branch, Canada Revenue Agency

Tax authorities spend most of their time and effort trying to establish certainty for taxpayers, governments, and citizens. Readers may disagree with this assertion, on the basis of their first-hand experience and, in some cases, their long careers spent dealing with the opposite of tax certainty. Understanding this difference in perspective—between tax authorities and everyone else—is an important part of understanding how tax administrators both reduce and contribute to tax certainty.

A Continuum of Behaviours
Tax administrators and readers of this article would all agree, ideally, that there is a continuum of situations and behaviours, from the certainty of voluntary compliance, to a zone of uncertainty, to a range of non-compliant behaviours (ending with criminal tax evasion) that even the affected taxpayers would recognize as illegal. Any taxpayer, accountant, lawyer, auditor, appeals officer, country, or judge might situate any specific case at different places on such a continuum. The debates and litigation arising from these individual cases can mask the fact that a tax administration and a tax-filing community have a shared interest in tax certainty.

With respect to the continuum of situations and behaviours proposed above, tax authorities work to manage two “lines.” The first line runs between (1) what is “clearly” compliant (which is one type of certainty) and (2) a range of uncertainty. The second line runs between uncertainty and what the CRA perceives to be non-compliant behaviour.

The CRA Audit Function: Focusing Effort on the Most Serious Issues First
The long-term goal of the compliance function—primarily, the CRA audit function—is to manage the incidence of non-compliance. Therefore, the second line referred to above (between uncertainty and the zone of non-compliance) is particularly important to the audit function. All tax administrations seek to clear out the area of non-compliance. We measure the tax gap associated with this space and communicate the gross audit yield as a proxy for progress in closing the gap.

Managing the Far End of Uncertainty
The CRA engages in ongoing work to communicate situations that it believes to be clearly non-compliant. Information on criminal convictions is made publicly available. Tax shelters that the CRA believes to be abusive are listed online. In 2019, the agency started to publish notices to practitioners in relation to planning that is being challenged at audit. The CRA’s corporate plans, ministerial announcements, and remarks by officials at conferences and other events routinely provide specific examples of areas of perceived non-compliance that are being prioritized by the agency.

Along the line between uncertainty and non-compliance, in areas where the CRA perceives notable non-compliance, the CRA seeks enhanced disclosure at the time of filing. The updating of the CRA’s approach to form T-1135, “Foreign Income Verification Statement,” in the mid-2010s is a good example of this. The CRA’s communications regarding form T-1134, “Information Return Relating to Controlled and Not-Controlled Foreign Affiliates,” in late 2019 were intended to transparently identify an area that was coming under closer scrutiny. In addition, the agency often communicates results specific to this context—for example, the dollar value of third-party penalties levied in a given year. From an administration perspective, we seek to clarify the issues that we will (or plan to) take on, and we are increasingly transparent in signalling ahead of time what these issues are.

Now consider some examples cited by my fellow contributors to the inaugural issue of this newsletter. The CRA’s round table remarks at conferences can be portrayed as introducing uncertainty because they move the CRA away from long-held positions, but they can equally be portrayed as reducing uncertainty because they provide the tax community with clarity about the CRA’s current views and intentions.

The CRA also listens, as does the Department of Finance, to contrary views on where the line between uncertainty and non-compliance is or ought to be. Thus, when the CRA discusses changes, communicates planned changes, or signals future plans, it is not only speaking to taxpayers but also listening to (while not necessarily agreeing with) them.
Litigating the limits of tax planning is costly and slow, and it brings uncertain outcomes for all parties. Because significant amounts of money and complex issues are in play, tax litigation will inevitably arise. However, if dialogue on issues can lead to common understanding, less litigation, or less scope for dispute, then CRA officials will continue to invest significant time in bringing such dialogue about.

Again, readers may doubt this assertion, on the basis of their own experiences. But keep in mind that when the CRA revamps a form, adds new audit teams, or makes multiple announcements in relation to an issue, we believe that we are providing certainty. We are saying, in effect, that we intend to challenge a certain approach by the taxpayer. I can appreciate that some taxpayers will accept the challenge and choose to defend a tax position. Others may choose to ensure that there is follow-up action from the CRA before they change their approach. Talk can be cheap, even from the CRA. But from a tax administration perspective, these are choices by the taxpayer to accept a certain level of uncertainty.

Managing the Border of Uncertainty

There is a natural tension toward one end of the continuum, where “clearly compliant” filings end and uncertainty begins. There is a zero-sum game relating to the tax paid.

The tax authority also considers cost of compliance (to the taxpayer and government), fairness across sectors and between taxpayers, and consistency (and potential friction) with other tax authorities.

Since taxpayers don’t normally flag their innovative tax positions to the CRA, the agency has a limited line of sight on where taxpayers think the line is between “clearly compliant” and “uncertain.” The Crown—through audit, rulings, appeals, the Department of Justice, and the Department of Finance—seeks to provide clarity on where that line is. These measures include efforts, initiatives, and practices that the CRA and other tax authorities deploy to better manage that line—measures that include moving the line along the continuum or expanding the range of filings and transactions that are compliant.

In recent years, the CRA has used rulings, notices to practitioners, and panel discussions at conferences to clarify where the zone of uncertainty starts. In some cases, such as the 2019 changes to the voluntary compliance program, some uncertainty was deliberately introduced, with the agency seeking to exercise more fully the minister’s discretion under the Act. To fill in more gaps, the CRA has provided guidance on systems of internal controls, feedback meetings with taxpayers, and notices from the Department of Finance.

In addition to the CRA’s initiatives, the OECD provides an element of global consistency, through working parties and broad policy directions from the Committee on Fiscal Affairs. Canada, through its leadership of the large business network, works to reduce uncertainty related to double tax. Double tax is a particularly disruptive source of uncertainty for tax authorities, given the high number of taxpayers with aggressive filings, the opportunity costs to the tax authority, and the opportunity costs to firms.

Although taxpayers’ business activities can sometimes push them into uncertainty, it is also the case that taxpayers sometimes seek to gain a tax advantage by structuring their affairs in a new or unique way. In that regard, taxpayers are leading and the CRA is reacting; the CRA is required first to identify and analyze the issue, then choose a response to address the taxpayer’s movement into the zone of uncertainty.

So What?

In the view of at least one tax official, there is a line on the continuum past which issues should be challenged consistently by the CRA. Thus, the CRA and taxpayers have a shared interest in maximizing dialogue in order to clarify that line and to minimize recourse to litigation as a means of setting it.

One suspects that the CRA’s compliance function both sees the necessity of litigation and has a sense of what can and should be avoided through better coordination of audit and enforcement activities. One suspects, too, that a taxpayer sometimes makes a choice to move into a zone of uncertainty.

Insights

In this article, I have sought to provide information that might help readers contextualize a given issue and understand some of the strategic interests at play. Insight into the different parties’ objectives and interests is the key to negotiating issues and influencing plans. Knowing whether you are on the edge or at the centre of the certainty continuum can give you insight into how you are being perceived, and it can help inform your work on resolving a given tax controversy or influencing a given approach or procedure.

Tax authorities think in terms of necessary uncertainty and avoidable uncertainty. The conduct of our own auditors, lack of coordination across the organization, or a failure to fully grasp the feedback or representations of taxpayers can push the tax administration into creating avoidable uncertainty. We work hard to minimize this.

Conversely, we perceive that some uncertainty may be necessary when plans or behaviours are considered carefully, appropriate consultations and deliberations occur, and the CRA addresses new areas of non-compliance or prioritizes certain issues. We are increasingly focused on providing certainty when we make such shifts. By doing so, we make the issue, in a sense, less about tax uncertainty and more about “outcome uncertainty” for taxpayers who are not moved by the CRA’s clear signals regarding its change of direction. Careful management of what the audit function takes on, the manage-
ment of litigation, and reactions to court decisions, timeliness, and consistency are all important in that regard.

Matters closer to the “compliance” end of the continuum are a lesser priority for the tax administration. Here, tax professionals are the first to address new transactions and plans, and they have some influence on how far along the continuum their initial position will be located.

In all cases, tax authorities have a responsibility to constantly clarify the location of these lines on the continuum. Tax professionals should be able to understand how much risk they are exposing their clients to in order to provide these clients with comprehensive advice.