The Role of the Attorney General in Tax Litigation

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Abstract
The large number of amendments introduced in tax legislation over the past 25 years—particularly with the addition of numerous new penalties and the adoption of more targeted and “aggressive” administrative practices—has resulted in the more frequent occurrence of “unfair” situations. The author examines the essential role of the attorney general in tax administration and offers some recommendations for changes to alleviate potential mishaps that can arise more easily in this context.

Keywords: litigation ■ settlement ■ administration

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Introduction
A little more than 25 years ago, I was asked by the Canadian Tax Foundation to write a paper on the role of the attorney general of Canada in income tax litigation.1 I was then still with the Department of Justice (DOJ).

My article was substantially inspired by what the late George W. Ainslie, QC had written in 1972.2 As many will remember, George Ainslie was a towering figure at

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the tax bar until his untimely death. I argued that, in the civil context, the relationship between the Canada Revenue Agency (CRA) and its counsel at the DOJ was, by and large, a solicitor-client relationship. Exceptions to that rule did exist in that it was also inherent in the duty of DOJ counsel to warn the CRA against

- any abuse of power,
- any infringement of fundamental rights or freedoms, and
- any curtailment or infringement of the general principles of due process.

I still think today that this is the correct view. In fact, the application of these principles is more important than ever, and that for a number of reasons.

**LEGISLATIVE CHANGES**

Over the past 25 years, Parliament has adopted a large number of tax administration oriented provisions to address serious concerns that it has identified.

For example, the tax shelter rules\(^3\) were enacted, quite correctly, to regulate an industry in which promoters often enticed investors on the basis that their particular tax shelter scheme worked. From the tax collector’s perspective, the results were not entirely satisfactory, to say the least: missed limitation periods (because these schemes could not be detected easily and quickly); assessments of tax and interest against investors who often argued their good faith and their reliance on the promoters; and the absence of any recourse (save possible criminal charges) that the CRA could institute against aggressive promoters and their advisers. The answer was the adoption of the tax shelter rules, far reaching in their breadth and armed with potentially severe consequences.

Another example is the transfer-pricing rules.\(^4\) Obviously, Parliament was concerned that Canadian and foreign multinationals could take undue advantage of the differences in tax systems by inflating acquisition costs or by simply exporting the rights to income. Complex rules were introduced, largely based on guidelines issued by the Organisation for Economic Co-operation and Development.\(^5\) Again, significant penalties were enacted, reflecting the magnitude of the proposed adjustments and the failure to provide sufficient contemporaneous documentation supporting the reported prices or transactions. Essentially, any capital or income adjustments that exceeded $5 million could be subject to a 10 percent penalty, not on the amount of taxes at issue, but on the gross amount of the adjustment(s).

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3. Section 237.1 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.


One final example was the introduction of the so-called third-party penalties, which can be raised against promoters or tax preparers. The underlying rationale was based on a recommendation made by the Technical Committee on Business Taxation and was an answer to the unfair results in many tax shelter arrangements, whereby investors were assessed and essentially lost their economic gains but the promoters bore no risk vis-à-vis the tax authority. Again, the penalties can be severe.

**ADMINISTRATIVE PRACTICES**

With these additions to the CRA’s arsenal, it should come as no surprise that the tax authority’s reaction was swift, and sometimes brutal. As Guy Du Pont and Michael Lubetsky correctly point out, tax auditors have substantial powers, the exercise of which can at times have very prejudicial and unfair consequences.

Audit techniques have evolved considerably. Formal requirements for documents and information are now routinely issued, often allowing for very little time to respond and thereby quickly quelling any resistance. The courts have strongly supported the tax authority in its sometimes insatiable quest for information. Basically, the only test is whether the requirement is issued for a purpose related to the administration of the Income Tax Act. In *Saipem Luxembourg SA v. Canada (Customs and Revenue Agency)*, in the context of a request for foreign-based information, the court ordered an examination of worldwide documentation even though the Canadian permanent establishment represented but a small fraction of the taxpayer’s entire business operation. Similarly, in *eBay Canada Ltd. v. Canada (National Revenue)*, the court authorized the disclosure of information stored electronically on US servers.

In addition, the climate and relationship between tax collector and taxpayer has undoubtedly grown more adversarial. As Canada’s Parliament has given its approval, other countries have begun adopting similar measures. These factors, combined with the general public perception that the CRA is right to pursue “taxpayers who are not paying their fair share” (a phrase now commonly used by politicians of all persuasions), have given strong impetus to various CRA audit initiatives. All of this, in large measure, is presumably for the better, since no one can argue in favour of tax evasion, nor does anyone suggest that tax loopholes should not be blocked.

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6 Section 163.2.
8 See the recent decision of *Guindon v. The Queen*, 2012 TCC 287; under appeal, FCA docket no. A-459-12.
9 See the article in this issue by Guy Du Pont and Michael H. Lubetsky.
However, there are dangers underlying these aggressive approaches. Without going into an in-depth analysis of all audits carried out in, say, the last 10 years, the one recurring concern appears to be the apparent, if not real, lack of accountability attaching to these audit initiatives. As matters currently stand, at least at the federal level, tax adjustments made at the audit stage are recorded, and give rise to whatever managerial consequences follow within the tax administration. For example, if sufficient audit adjustments are made, the result could be an increase in audit personnel or in classifications. Obviously, audit teams are judged, at least in part, on the results they have achieved.

Though this practice may, to some degree, reflect sound management techniques, in various instances it is also seriously flawed. Assume, for example, that as a consequence of the objection process or a court decision, an audit adjustment is overturned. What then? Under the current system, no real consequences flow (apart, of course, from the refund of taxes and resulting interest); that is, there are no consequences at the audit level. Take as an example the recent decision of the Supreme Court of Canada in *Canada v. GlaxoSmithKline Inc.* Very significant audit adjustments were made under both part I (refusal of acquisition costs of the ranitidine product by the Canadian entity) and part XIII of the Act (treating the adjustment amount as an appropriation). The Supreme Court held that these adjustments were wrong and ordered the parties to return to the Tax Court of Canada, where undoubtedly, via either an agreement or a new court determination, new adjustments will be made. Almost certainly, regardless of how the case is decided, these new adjustments will represent but a portion of the original position. Should this be the case, both parties could afford to again fight all the way to the Supreme Court. This is obviously not true in all circumstances.

What, then, are the solutions? I have always been and continue to be in favour of a balanced approach. There are obviously cases that are of the all-or-nothing type. They are rare. Most cases are complex enough, and the factual underpinning is sufficiently flexible, to justify a compromise settlement.

It is true that Canadian case law appears to limit the possibility to settle to only those situations were the legal result achieved is one that could receive judicial approval. To quote from the seminal case on the matter, *In re Galway v. MNR*, “the Minister has a statutory duty to assess the amount of tax payable on the facts as he finds them in accordance with the law as he understands it.” More recently, the Federal Court of Appeal reaffirmed these principles in *CIBC World Markets Inc. v. Canada.*

That said, it is always possible for the parties to agree on factual determinations that can then justify the appropriate legal result. It is unfortunate that our jurisprudence has not seen fit, and has proved to be insufficiently flexible, to follow the

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12 2012 SCC 52.
13 74 DTC 6355, at 6357 (FCA).
14 2012 FCA 3.
model upheld by the House of Lords in *IRC v. Federation of Self-Employed.*\(^{15}\) In that case, the revenue authorities had made an arrangement with self-employed unionized workers in the printing industry (known as the “Fleet Street casuals”) who had failed to report their income appropriately. The settlement called for measures to be taken by the employers and unions to ensure compliance in return for relinquishing potential criminal sanctions and providing for a prospective only settlement.

The Federation of Small Businesses challenged this arrangement, which in effect had granted an amnesty to the affected workers, and requested an order of mandamus to assess and collect income tax “according to the law.” The House of Lords analyzed the situation as follows:

But I do not accept that the principle of fairness in dealing with the affairs of taxpayers is a mere matter of desirable policy or moral obligation. Nor do I accept that the duty to collect “every part of inland revenue” is a duty owed exclusively to the Crown. Notwithstanding the *Treasury* case in 1872, I am persuaded that the modern case law recognises a legal duty owed by the Revenue to the general body of the taxpayers to treat taxpayers fairly, to use their discretionary power so that, subject to the requirements of good management, discrimination between one group of taxpayers and another does not arise, to ensure that there are no favourites and no sacrificial victims. The duty has to be considered as one of several arising within the complex comprised in the care and management of a tax, every part which it is their duty, if they can, to collect. . . .

The Revenue were in no way arrogating to themselves a right or inviting assumption of an arrogation to themselves of a right not to comply with their statutory obligations under the statutes to which I have referred. On the contrary, their whole case was that they had made a sensible arrangement in the overall performance of their statutory duties in connection with taxes management, an arrangement made in the best interests of everyone directly involved and, indeed, of persons indirectly involved, such as other taxpayers, for the agreement reached would be likely to lead ultimately to a greater collection of revenue than if the agreement had not been reached or “amnesty” granted.\(^{16}\)

Two potential solutions deserve, in my view, closer consideration.

1. *Expansion of the policy in the administration of subsection 220(3.1).* Subsection 220(3.1) allows the CRA to waive or cancel all or any part of a penalty or interest otherwise payable under the Act by taxpayers. Obviously, this is a discretionary power. The Federal Court has, on a number of occasions, indicated that as long as the CRA follows and acts in accordance with its public guidelines—*Information Circular 07-1, “Taxpayer Relief Provisions”*\(^{17}\)—it will not interfere

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\(^{15}\) [1981] 2 All ER 93 (HL). See also *Matrix-Securities Ltd. v. IRC,* [1994] 1 All ER 769, at 791 (HL), and *Preston v. IRC,* [1985] 2 All ER 327 (HL); and contrast these decisions with the rather inflexible position in *Ludmer et al. v. The Queen,* 95 DTC 5311 (FCA); leave to appeal denied, [1995] 4 SCR vii.

\(^{16}\) *Federation of Self-Employed,* supra note 15, at 112 and 119.

or substitute its judgment for that of the CRA. These guidelines provide potential for relief where delays not attributable to the taxpayer, financial hardship, or “extraordinary circumstances” (defined very strictly) exist. In my view, a more liberal approach would be justified. Take, for example, the situation of a taxpayer who has been assessed in respect of five issues for amounts aggregating $10 million, including interest. Assume that the issues are resolved at the court level, 6 or 7 years after the issuance of the reassessment, at an amount of tax of $300,000. Presumably the taxpayer when faced with the original assessment was in no position to pay to resolve the issue. Should she not be entitled to get interest relief on the remaining outstanding tax liability, which now attracts interest computed for 9 or 10 years? In my view, clearly she should, since the “settlement” recognizes that the original assessment was substantially erroneous. However, under the current guidelines and their interpretation by the tax authority, it is doubtful that relief would be granted.

2. Allow settlements based on risks of litigation. The Mintz report recommended this approach, which is recognized and applied in the United States.

Section 5(d) of Canada’s Department of Justice Act provides:

5. The Attorney General of Canada . . .
   (d) shall have the regulation and conduct of all litigation for or against the Crown or any department.

One would have thought that this provision was broad enough to allow wide discretion to the attorney general of Canada to resolve tax disputes. However, given the Gateway line of cases and the refusal to follow the British courts’ reasoning, an amendment to the Act that would specifically deal with settlement principles is required. As matters presently stand, in all-or-nothing situations, we are left with decisions by the CRA’s officials to proceed to litigation even if their chances of success are low.

Even though these suggested solutions may or may not be implemented, one of the most important aspects of the tax litigation process remains the role of DOJ counsel. My experience and interaction with DOJ counsel over the years has, in that regard, been generally excellent.

Moreover, the courts have recognized that the role of DOJ counsel is somewhat different than that of practitioners representing the interest of a private litigation. DOJ counsel have a duty, of course, vis-à-vis the court, but also vis-à-vis the community at large.

18 See, for example, Jenkins v. Canada (Revenue), 2007 FC 295; Hauser v. Canada (Revenue), 2007 FC 113; and K-Bel Holdings Inc. v. Canada (Customs and Revenue Agency), 2006 FC 825.
19 Supra note 7, at 10.9.
It is for that reason that the courts have indicated that

counsel representing the Attorney General of Canada does not need the authority of
the officials of the tax department or the CCRA [CRA] to settle litigious matters that are
within the ambit of paragraph 5(d) [of the Department of Justice Act]. They can bind
the Government of Canada in such proceedings.21

Moreover,

[t]he Crown never loses a case and the Crown never wins a case.22

In practical terms, what does this mean? In the criminal context, the principle
has often been cited: a criminal prosecutor’s duty is first and foremost to “seek
justice” rather than to seek to convict.23 Undoubtedly, the courts have applied simi-
lar principles to the duty of counsel in a civil context.

Berenson24 conveniently regroups the “rules of conduct” into three general
categories:

1. the lawyers’ duty to represent their clients “zealously” within the bounds of
the law;
2. the duty of confidentiality; and
3. conflicts of interest.

In respect of each of these categories, distinctions can and should be drawn between
the professional obligations of DOJ counsel and those imposed on a member of the
private bar.

In a civil tax litigation context, this should translate, at a minimum, into the ap-
plication of the following guidelines:

- DOJ counsel should always act in the interest of justice and the research of the
  truth.
- If DOJ counsel is aware of facts or documentation that favours the position of
  the taxpayer (who may not have knowledge of or access to such information),
  he or she should produce it without hesitation.25
- A subset of the “interest of justice” rule is that DOJ counsel should seek to do
  all that he or she can to achieve a result that is fair and right.

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21 Jackman v. The Queen, 2000 DTC 2161, at paragraph 27 (TCC), per Bowman J.
22 E. Nielson v. MNR (1963), 33 Tax ABC 257, at 263, per commissioner Fisher.
23 Steven K. Berenson, “The Duty Defined: Specific Obligations That Follow from Civil
Government Lawyers’ General Duty To Serve the Public Interest” (2003) 42:1 Brandeis Law
Journal 13-70; and the line of cases beginning with Boucher v. The Queen, [1955] SCR 16.
24 Ibid.
25 See Brady v. Maryland, 373 US 83 (1963) (United States Supreme Court in a criminal context);
and Gray Panthers v. Schweiker, 716 F. 2d 23 (DC Cir. 1983) (in a civil context).
As indicated earlier, our tax legislation is now replete with provisions providing for potentially very harsh penalties that could cripple businesses. DOJ counsel should always consider whether, in particular circumstances, the application of these provisions to their full extent is warranted. I have in mind, for instance, the situation in _Guindon v. The Queen_,\(^\text{26}\) where an inexperienced lawyer, as a result of providing a faulty opinion for which she was paid $1,000 in fees, was subjected to penalties under section 163.2 amounting to almost $550,000. Although the CRA’s argument in that case may have technical merit, the question remains as to whether, in the circumstances, imposing penalties of this magnitude was justified and achieved the true purpose of those provisions.

DOJ counsel should not resort to litigation tactics that, in the circumstances of the case, are “not fair.” The CRA has available to it substantial resources and powers that, if used “improperly,” can result in a denial of justice. Examples of situations where careful judgment must be applied include the issuance of multiple requirements with short timelines provided; hard-nosed positions taken; and the imposition, as a result of the application of the well-known rules of onus of proof, of the obligation to establish facts where an agreement to proceed by way of samples (thus reducing time spent, witnesses required, and fees) would have been reasonable.

DOJ counsel should assess the evidence at hand in terms of what he or she perceives would be a court’s reaction. CRA auditors are often not familiar with the rules of evidence, and it is therefore incumbent on DOJ counsel to ensure that assumed facts are not, in appropriate circumstances, based on an erroneous or incomplete understanding of the rules.

Admittedly, these rules of conduct have often been discussed in a US context.\(^\text{27}\) However, they seek to achieve, at least in a litigation environment, a process that is fair and a result that is just.\(^\text{28}\) As the Australians would put it, the government should be a “model litigant.”\(^\text{29}\) That does not mean that “firmness” is incompatible with “fairness.” As Leader explains,

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\(^{26}\) Supra note 8.


[a]s to fairness, the Commonwealth should act consistently in handling claims; deal with claims promptly; pay legitimate claims; and enter into reasonable settlements. It should not seek to take advantage of an impecunious opponent; contest matters which it accepts as correct; rely on purely technical defences where it has suffered no prejudice; or pursue frivolous appeals. The Commonwealth should also apologise where appropriate.

As to firmness, the Commonwealth should not cave in to spurious or vexatious claims; or take a “soft” approach. Instead, it should appropriately test all claims; rely on legal professional privilege where appropriate; make public interest privilege claims objecting to disclosure of information; seek security for costs where appropriate (in one case the Commonwealth obtained an order for $4 million security for costs); oppose oppressive subpoenas/discovery; seek to strike out untenable claims; and act properly to protect the Commonwealth’s interests.30

Undoubtedly, the tax litigators in the DOJ do take their role very seriously and in most instances do attempt to “do the right thing.” It is indeed remarkable that so many cases that have gone through the audit and objection phases can still be settled at the litigation stage. It is to be hoped that this state of affairs continues, and that unfair situations become less prevalent.
