Some Thoughts on Disclosure Rules in Canada: A Peek into the Future

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Abstract
Canada and Quebec have recently introduced disclosure rules that attempt to thwart aggressive tax-avoidance schemes at the planning stage. These rules are intended to provide an alternative to reliance on general anti-avoidance rules, enacted in both jurisdictions, which also attempt (with limited success) to challenge such schemes but apply only after tax returns have been filed and audited. Disclosure rules do not represent a policy unique to Canada or Quebec; several other jurisdictions around the world have already introduced similar, though not identical, measures in the recent past. The purpose of these disclosure rules is to change the odds of winning in the aggressive tax-planning lottery, by requiring advance reporting requirements for schemes where specific characteristics are present. Failure to report can lead to undesirable consequences, such as an extension of the normal reassessment period and the application of penalties. Canada opted for mandatory reporting only, while Quebec, though having selected a similar tool, has also opted for a preventive filing requirement. These measures are likely to stay on the books for a long time, but should be complemented by a review of the design of the existing general anti-avoidance rules, which would provide better guidelines for the courts to apply when aggressive schemes are challenged by the tax administration through the judicial system.

Keywords: Anti-Avoidance Rules • Disclosure • GAAR

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INTRODUCTION

When I was invited to prepare this short article on disclosure rules aimed at preventing aggressive tax-avoidance schemes, it was suggested that I offer my view on what is likely to be the situation in anti-avoidance matters in Canada 25 years from now. Disclosure rules are used in several countries, either on their own or as a complement to some form of general anti-avoidance rule (GAAR) included in tax legislation. The aim of both sets of measures is to reduce the taxpayer’s odds of winning in the lottery of aggressive tax planning.

In this attempt to read the crystal ball, I am tempted to invoke the cautionary words of John Maynard Keynes: “In the long run, we are all dead.” As a practical matter, I must also note that disclosure rules raise a myriad of questions and issues that cannot be adequately covered in such a short article. Keeping these caveats in mind, for those only loosely familiar with such measures, I will begin by briefly reviewing the context in which disclosure rules have been framed, along with their key features. In the discussion that follows, I will focus mainly on the disclosure rules enacted by the Quebec government in 2010 and proposals to adopt similar rules introduced by the Canadian government in the same year but not yet enacted. I will also comment briefly on the policies and practices of other countries in dealing with the problem of aggressive tax avoidance.

BACKGROUND

In the last 20 years, an economic tidal wave swept the world. Over that time span, important political and economic changes took place in several major countries, often resulting in large-scale international dispersion of businesses reaching for lower costs and economies of scale. These changes and others led to the astounding rates of growth observed in particular in China, India, Brazil, and several countries in the South Pacific. Strategic planning on a global scale also led to changes in the role of tax specialists. As a result of the proliferation of complicated tax rules, instead of being consulted after plans were made, tax advisers were invited into the boardroom and given full participation in strategic decision making. Business schools everywhere fuelled this tendency by producing tax professionals in growing numbers.

1 John Maynard Keynes, A Tract on Monetary Reform (London: Macmillan, 1924), at 80. For a debate on the significance of the words used by Keynes, see http://thinkmarkets.wordpress.com/2010/06/28/%E2%80%9Cin-the-long-run-we-are-all-dead%E2%80%9D-what-does-it-mean/.

numbers, only some of whom sought employment in government, with the majority joining the ranks of the private sector.

Of course, tax planning has always been important in structuring transactions of companies domestically, as well as transactions between local businesses and affiliates abroad. In Canada, the federal government and, notably, the government of Quebec have long been fighting aggressive tax planning, through specific anti-avoidance provisions sprinkled throughout their tax legislation. Taxpayers have often challenged these measures in the courts, though with mixed success.

Strapped for cash and also wanting to create a more level playing field for all stakeholders in tax planning, the government of Canada opted in 1988 to enact a GAAR, which is found in section 245 of the Income Tax Act (ITA). Quebec harmonized its Taxation Act to include a GAAR for provincial income tax purposes. In a nutshell, the Canadian GAAR applies if a tax benefit has been obtained from a transaction the primary purpose of which was to obtain the tax benefit, and if this results in a misuse or abuse of the ITA. If the taxpayer accepts the assessment under GAAR or loses his appeal in the Canadian judicial system, the challenged tax benefit is to be paid back without any penalty. Since there were no repercussions other than paying back what had been gambled plus interest—should the tax authorities first manage to identify and audit the particular avoidance transactions—and since court decisions were and still are often unpredictable, aggressive tax planning skirting the law became a less risky bet, resting on a more favourable net risk assessment stance by taxpayers and their advisers.

Both the Quebec and the federal governments have decided to act upon the problem by introducing disclosure rules as a countervailing measure. For the purpose of this short piece, the following provides an overview of the main parameters of the transactions to be disclosed and the consequences for failure to file, but will not address differences such as those regarding the timing of disclosure and the treatment of a series of transactions.

**QUEBEC DISCLOSURE RULES**

When it became clear in the 1990s that several aggressive schemes had been set up to avoid the provincial GAAR, the Quebec finance minister issued several warnings over the years and finally intervened. An announcement was made in the provincial 2008-9 budget that a green paper was being prepared on the challenges that aggressive tax planning created for the provincial treasury. This was to be followed by a

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4 Taxation Act, RSQ, c. I-3.
5 For a listing of the court decisions on the Canadian GAAR, see the discussion by David Sherman, ed., Practitioner’s Income Tax Act, 41st ed. (Toronto: Carswell, 2012), at section 245, which clearly shows that there has been wide division in judicial decisions.
consultation period, before the enactment of any measures proposed in the paper. The finance minister also announced the creation of a special administrative unit within Revenu Québec regrouping new and existing audit forces dedicated to the management, detection, and obstruction of aggressive tax-avoidance schemes. The new unit, created under the name of la Direction de la lutte contre les planifications fiscales abusives, was given an initial budget of $5.3 million to launch its activities.7

The green paper was published in January 2009.8 It contained various proposals to revise the legislative framework to curb aggressive tax planning in Quebec—or at least to alter the risk:reward ratio in such a way as to discourage taxpayers from engaging in such planning. During the consultation period, some worrying concerns expressed by taxpayers and tax professionals were cleared up. Disclosure rules were announced in Information Bulletin (BI) 2009-5, on October 15, 2009.9 These proposals were integrated into Bill 96, presented in May 2010, and were subsequently incorporated in the Taxation Act later that year, under book X.2, starting with section 1079.8.1, generally for transactions undertaken after October 14, 2009.

The new rules were designed to change the odds of the tax audit lottery by granting Revenu Québec earlier access to complex tax schemes, thus allowing auditors to obtain more detailed information and generally giving them sufficient time for a more thorough audit of such schemes if warranted.

The Quebec disclosure rules have two components: a mandatory reporting mechanism for certain transactions that bear at least one of two characteristics typically present in aggressive tax planning; and a preventive reporting mechanism for any transaction that could be subject to the provincial GAAR. More particularly, if a transaction is subject to the provincial GAAR, failure to duly file form TP-1079.DI, which is to be used for both mandatory and preventive disclosures, will lead to the extension of the normal reassessment period and the application of penalties. This form, which was first released in April 2010, is a very sophisticated 11-page document10—one could almost call it a short essay rather than a form—and it adds yet another layer to the number of tax-related documents that businesses must produce.

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7 For some detail on the operations of the unit, see http://www.revenuquebec.ca/en/a-propos/planification_fiscale_abusive/measures.aspx.
10 Revenu Québec, form TP-1079.DI, “Divulgation obligatoire ou préventive d’une planification fiscale” (www.revenuquebec.ca/documents/fr/formulaires/tp/tp-1079.di(2011-12).pdf). This form is to be filed using the French version only. The English version that can be consulted is for information purposes only, and has no official status. The form also mentions that all communications with the authorities must use the French language when the corporation is established in Quebec.
The following provides a short overview of the main parameters of the mandatory and preventive disclosure rules, and a general assessment of their implications for taxpayers.

**Mandatory Disclosure**

Mandatory disclosure is required for any transaction that was developed under confidentiality arrangements or conditional fees and that results for the taxpayer in a tax benefit of at least $25,000 (or modifies the taxpayer's income by at least $100,000). Such schemes are often characterized by mass marketing.

Failure to file the disclosure form on time and accurately leads to a penalty ranging between $10,000 and $100,000.

The normal reassessment period starts to run from the time that the mandatory disclosure form is duly filed. However, if a transaction has not been disclosed and is subject to a GAAR-based challenge by Revenu Québec, the latter is entitled to issue a GAAR-based assessment beyond the normal reassessment period and is also entitled to apply a penalty. More specifically, the reassessment period that would otherwise apply, which is normally three or four years, may be extended by three years, and a penalty may be imposed that is equal to 25 percent of the tax benefit denied under the provincial GAAR. While a due diligence defence can be raised, Finances Québec was vague about its chances of success, leaving the matter to be settled by a review of the relevant jurisprudence and its application to the facts of each case.

**Preventive Disclosure**

Preventive disclosure is required for any transaction that could be subject to the provincial GAAR even without the presence of the hallmarks under the mandatory reporting regime. Again, failure to report the transaction by filing form TP-1079.DI in a timely manner may lead to an extended reassessment period as well as a GAAR-based penalty.

Specifically, failure to file a preventive disclosure form in respect of any transaction that is subject to the application of the provincial GAAR may result in a three-year extension of the normal reassessment period and a penalty amounting to 25 percent of the tax benefit denied under the provincial GAAR. The promoter of the transaction could also be liable to a penalty that is equal to 12.5 percent of the fees that the promoter is entitled to receive in respect of the unreported transaction.

These rules represent a drastic change from Finances Québec's previous policy. In light of the potential consequences of non-disclosure, taxpayers now have to make a GAAR-based risk assessment in deciding whether or not to report certain transactions.

**General Assessment**

The filing of the disclosure form under either the preventive or the mandatory reporting requirements creates no implied admission by the taxpayer that the claims to the tax benefits from the reported transaction have been relinquished under any
particular tax provisions, including the provincial GAAR. That said, what other reason would there be for a taxpayer to file except uncertainty about the legality of the scheme? Filing provides assurance that the GAAR-related penalty and the extension of the limitation period will not be applied, regardless of any conclusion by the courts with respect to the application of the provincial GAAR to the particular transaction.

The rules thus create a strong incentive to file and to do so on time, in order to avoid the consequences of non-disclosure. It is not likely that large numbers of mandatory disclosures will be made, since the mass marketing of tax-avoidance schemes is largely a thing of the past, and presumably the presence of these measures in the Taxation Act will serve as a warning to anyone who might contemplate engaging in such activities in the future. (I note, however, that this opinion is purely intuitive, since Revenu Québec does not publish any statistics related to disclosures.)

It is perhaps preventive disclosure that the authorities hope will be the most significant deterrent to aggressive tax planning. This type of reporting requirement forces a taxpayer who considers setting up an aggressive tax-avoidance transaction to assess the potential consequences of engaging in it.

Since it is certain that any preventive filing will put up a red flag, taxpayers are likely to base their decision to file a disclosure form on a risk assessment of the potential application of the provincial GAAR by Revenu Québec. Taxpayers may also fear that the Canada Revenue Agency (CRA) will attempt to systematically obtain these Quebec disclosure forms, thus adding another level of uncertainty. Because Revenu Québec does not release information on the number of forms filed, any further conclusions on this point remain an exercise in guesswork, at this stage at least.

THE CANADIAN DISCLOSURE RULES

Following in the footsteps of other jurisdictions—notably the United States, the United Kingdom, and Quebec—the Canadian government announced in its March 2010 budget the broad parameters of a new information-reporting regime for tax-avoidance transactions and stated that there would be public consultation on the details of the regime.11 More information followed on May 7, 2010, indicating that avoidance transactions would be subject to mandatory disclosure if at least two of three hallmarks (or characteristics) existed in respect of the transaction (defined under the rules as a “reportable transaction”).12 Draft legislation (proposed section

11 Canada, Department of Finance, “Backgrounder and Description of the Proposals,” issued with News Release 2010-043, infra note 12.

237.3 of the ITA) was released on August 27, 2010 with detailed explanatory notes.\textsuperscript{13} Subsequently, the Department of Finance issued a comfort letter to allay some concerns raised by the Canadian Bar Association about the impact of the proposed rules on solicitor-client privilege.\textsuperscript{14}

\textbf{Mandatory Reportable Transactions}

The federal hallmarks for reportable transactions are roughly similar to those present in the Quebec mandatory disclosure rules. For the federal government, the selected hallmarks reflect circumstances that typically exist in tax-avoidance transactions and that indicate a greater likelihood that the underlying transactions could be challenged. Specifically, they are identified as conditional fees, confidential protection, and contractual protection in respect of the tax benefit that could result from a transaction the primary purpose of which is to obtain the tax benefit. The August 27, 2010 explanatory notes detail the particulars of each of these hallmarks.

The consequences of not filing are, however, different from those under the Quebec rules. As proposed in the draft legislation, failure to provide timely and full disclosure of a reportable transaction on the part of the taxpayer and other participants in the transaction would lead to withholding of the tax benefit sought until disclosure is filed and any applicable late-filing penalties are paid. More specifically, failure to duly file the information-reporting form in respect of the reportable transaction would allow the CRA to strike down the tax benefit to be obtained from the transaction irrespective of the application of subsection 245(4) of the ITA (the federal GAAR). In other words, the CRA would not have to argue that there is a misuse or an abuse of the ITA to deny the tax benefit from the reportable transaction. That said, following the CRA’s review of the late-filed form and other relevant documents, and the payment of any late-filing penalties, the taxpayer may or may not be reassessed under section 245 of the ITA in respect of the reportable transaction.

The late-filing penalty is equal to certain fees that promoters and tax advisers are entitled to receive in respect of the reportable transaction. A defence of due diligence is possible, but the result is uncertain. The taxpayer as well as the promoters and the tax advisers are jointly and severally liable to pay the penalty, with the exposure of promoters and tax advisers being limited to the amount of their respective fees. No limitation period applies for the penalty to be assessed.


\textsuperscript{14} Comfort letter dated January 11, 2011, addressed to the president of the Canadian Bar Association and the chair of its national taxation law section, and signed by the minister of finance.
General Assessment

The federal rules are of narrower scope than the rules adopted in Quebec. They do not provide for preventive disclosure, or for an extension of the reassessment period or a GAAR-based penalty.

As in Quebec, filing the form at the federal level would not constitute an admission by the taxpayer that the transaction in question offends section 245 of the ITA. Taxpayers would file because of their uncertainty about the possible application of GAAR, and their exposure to payment of the penalty for non-disclosure.

One can wonder about the different approaches adopted by the two levels of government. In my opinion, the carve-out of subsection 245(4) in the federal rule is the wiser decision, since it takes into account the practical difficulties of raising and eventually winning the argument that there has been a misuse or abuse of the Act. On the other hand, especially in light of current budgetary cutbacks at the CRA, it would have been useful to extend the reassessment period in order to avoid the situation where audits remain incomplete because the time normally available proves to be insufficient. Such an extension would further alter the risk:reward ratio for taxpayers and their advisers.

DISCLOSURE RULES ABROAD

Disclosure rules represent an attempt to close the barn door before the horses have left, as opposed to the Canadian GAAR, which effectively leaves the government chasing an unknown number of horses scattered in the wild after they have found the open door. Disclosure rules exist in a number of other jurisdictions as well. The United Kingdom introduced its mandatory regime in 2004. The United States also has adopted reporting requirements for certain transactions, though under different names and with different features. Ireland has recently introduced a form of non-disclosure penalty called “protective notification.” New Zealand, for its part, uses other methods such as questionnaires requiring mandatory responses. Enhanced relationships between tax administrations and taxpayers have emerged in Australia and the Netherlands, all aimed at voluntary disclosure of relevant planning operations. Disclosure rules can take other forms in different countries and can also be combined.

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15 For a cursory view of the US rules, see, for example, the Current Tax Reading feature (2011) 59:4 Canadian Tax Journal 915-36, at 919-21.
There is no doubt that disclosure rules represent one of the most useful solutions to diminish the interest in aggressive planning schemes on the part of taxpayers and their advisers. Increasingly, jurisdictions have adopted such rules, convinced of their utility as early warning systems and as tools that allow tax administrations to focus on the sectors where the likelihood of tax avoidance is greatest, and thus to target their resources at gaining a clearer understanding of the structures used to circumvent tax laws. In my opinion, such rules are here to stay, though they may be modified over time, depending on whatever new strategies may be devised by taxpayers and their advisers.

While the efficiency of disclosure rules will become clearer over the next few years, it may be much longer before we see a final resolution in many cases currently in dispute, as they proceed through the various levels of appeal. Furthermore, the very existence of disclosure rules likely will lead to another cat-and-mouse game between ingenious advisers and potentially overloaded revenue officials, who might not have sufficient real-time knowledge to anticipate and block the use of more sophisticated tool kits developed by tax teams in the private sector. Meanwhile, tax advisers will no doubt try to attack the legitimacy of substantive law concerning reportable transactions.

**WHAT MIGHT BE THE CANADIAN SITUATION IN 25 YEARS?**

It is essential to remember that aggressive tax avoidance is a problem that touches all stakeholders—taxpayers, their tax advisers, the tax administration, and courts of justice. In an earlier article published in the *Canadian Tax Journal*, my co-authors and I tried to come to grips with the concerns of each of those stakeholders, viewed in the context of widely accepted principles of a sound taxation system—namely,

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predictability, simplicity, effectiveness of disclosure rules (if any), and finally the all-important principle of fairness. We presented these principles and concerns in matrix form, which then led us to elaborate a flow chart linking the various tools that may be used to counter aggressive tax planning.

Unless corporate income taxes are abolished (an unlikely prospect) along with the numerous tax benefits attached to such taxes (for example, faster depreciation rates, tax credits, reduced tax rates, or special deductions) and are replaced in large part by other forms of consumer-based tax (with their own set of particularities), the basic need will remain for timely information related to complex income tax strategies. This requirement should respect the principles enumerated above.

Where else might we see improvements in the fight against aggressive tax avoidance over the next 25 years?

Trying to bring about a more level playing field requires intervention not only through disclosure rules, but also through a satisfactory regime for issuing an assessment when specific anti-avoidance rules are difficult to apply. A GAAR is likely to remain an appropriate tool for reaching a settlement, perhaps as a tool of last resort in some cases. Such a GAAR must be employed in such a way as to be respected by all stakeholders.19 From a recent paper published by PricewaterhouseCoopers (PWC),20 it appears that more and more countries are considering or have already adopted a form of GAAR, through a legislated rule. The paper identifies 17 countries with various types of GAAR. There is no single model that fits all jurisdictions. For example, some GAARS operate through a statute while others are judicially developed. Some jurisdictions (such as the United States) use both approaches. The range of choices raises the question of whether we in Canada might consider modifying our own GAAR.

According to the PWC paper, a GAAR should embody the following principles and characteristics:

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19 In a recent note to the British House of Commons, Antony Seely reviews the problems associated with the multiplication of targeted anti-avoidance rules in the United Kingdom since 1997, and the see-saw position of successive governments on the question of introducing a GAAR, which still is on the drawing board in that country. Without proposing the outright introduction of a UK GAAR, Seely suggests that the primary purpose of a statutory GAAR is not to blindly banish tax avoidance, but rather to address the fundamental causes of tax avoidance and reform the system accordingly. See Antony Seely, *Tax Avoidance: A General Anti-Avoidance Rule—Background History*, Standard Note SN02956 (London: House of Commons Library, July 26, 2012) (www.parliament.uk/briefing-papers/SN02956), at 27. For further recent introspection, see also Antony Seely, *Tax Avoidance: A General Anti-Avoidance Rule (GAAR)*, Standard Note SN06265 (London: House of Commons Library, September 18, 2012, amended October 1, 2012) (www.parliament.uk/briefing-papers/SN06265), which provides interesting points of view from the private sector in close cooperation with parliamentary committees, a rarity in Canada.

- certainty of application: clearly stated policy intention;
- extensive guidance and consultation for the taxpayers;
- fairness, due process, checks and balances;
- evidence-based analysis;
- an independent panel to serve in a consultative role to revenue authorities;
- misuse or abuse provisions applied by tax authorities, with the burden of proof regarding the operation being borne by taxpayers;
- treaty override provisions;
- safe harbour provisions;
- advance clearance or a ruling that GAAR will not apply in taxpayer-specific factual circumstances.

Canada’s GAAR respects several of the principles, though there is, for example, no independent panel in the application of GAAR. While section 245 of the ITA may appear fair, the often divided opinion of the courts as to whether there has been a misuse or abuse of the law reflects different personal opinions among judges about where the limits of the test really lie. Of course, this can be explained in good part by the fact that each GAAR case is unique and fact-driven. The Canada Trustco case\textsuperscript{21} seemed to provide a clear path of reasoning: the judges used a textual, contextual, and purposive approach in their search for a reasonable solution to decide whether GAAR applied, and that approach has been followed in subsequent cases.

In my opinion, however, Canadian courts could sometimes be hard pressed to find in the tax law the object of many tax rules that have been introduced over the years. Provisions have been drafted year after year to patch over a gap left by previous legislators with little, if any, detailed explanation of the circumstances in which the new measures were adopted. It becomes a very difficult task to go back in time and try to determine what the changes really meant, especially where the purpose of the changes is not clearly articulated in the law. Eventually, extrinsic material such as explanatory notes came to be provided with draft legislation, but they do not always fill in all of the historical gaps. The Lipson decision\textsuperscript{22} clearly shows that the highest court in Canada can be divided even if a majority comes up with a decision, because the perception of what is an important factor often varies from person to person, in the absence of sufficiently clear statutory guideposts.

Canadian tax legislation has generally become extremely complicated in terms of its outcomes and requires more than cosmetic surgery, along the lines pursued by Australia and New Zealand. Perhaps Canadian legislators may wish to try to reduce uncertainty in the future for all stakeholders by beefing up subsection 245(4) of the ITA to clarify the kinds of situations that result in a misuse or abuse of the tax law, rather than leave the courts to fend for themselves and apply what they consider appropriate judicial guidelines while important tools are missing in the tool box.

\textsuperscript{21} Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54.

\textsuperscript{22} Lipson v. Canada, 2009 SCC 1.
supplied by the legislator. For example, Canadian legislators could adopt some of the elements incorporated in the US codification of the economic substance doctrine. This approach is oriented toward an objective assessment of the economic and financial aspects of transactions. If employed in Canada, it would also help to better maintain the integrity of the tax system.

In summary, then, what I foresee is that disclosure rules will still be here 25 years from now. There will also be a growing tendency worldwide to adopt statutory anti-avoidance rules. After the pangs of birth, there will be a general move to clarify the GAAR or quasi-GAAR in the tax legislation of all jurisdictions. Such clarification could provide the courts with appropriate tools to apply a GAAR more consistently. A likely means to this end lies in including the economic substance doctrine, in some fashion, in the corpus of Canadian tax legislation. Voices will also be raised to remove the cobwebs from the tax legislation, and to revamp large portions of it, much as, some years ago, insurance companies were forced to change the small print in their policies into readable English for the average person.

**POSTSCRIPT**

Since this article was written, a third government in Canada—Ontario—has proposed the introduction of disclosure rules along the lines of the federal ones. As stated in Ontario’s 2013 budget,

> the government will be proposing legislation to introduce new disclosure rules for aggressive tax avoidance transactions similar to the rules introduced by the federal government as part of Bill C-48 in November 2012. This new measure would require taxpayers to report aggressive tax avoidance transactions that attempt to avoid Ontario tax.

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24 See also Brett Wells, “Economic Substance Doctrine: How Codification Changes Decided Cases” (2010) 10:6 Florida Tax Review 411-57. This article provides some insights into how past court decisions would have been different if codification of the economic substance doctrine had been in place at the time.