

### RISK-BASED ASSESSMENT OF LARGE CORPORATIONS

The Canada Revenue Agency (CRA) currently audits large corporate taxpayers on a regular basis. To improve efficiencies and cash recoveries, the CRA is moving to a risk-based assessment approach to such audits. Over the next five years, corporate taxpayers will be assessed as low, medium and high risk, based on a series of factors. The frequency and intensity of the audit processes will vary directly with the risk ascribed to the particular taxpayer. Consequently, large corporations that currently face consistent audit scrutiny may find that CRA audit work abates or becomes more focused on specific areas in which significant tax liabilities may arise. Two areas of continuing review involve transfer pricing and "aggressive tax planning," which the CRA regards as arrangements resulting in tax benefits, which comply with the letter but not the spirit of the Canadian *Income Tax Act* (ITA).

### INCREASED DEMANDS FOR INFORMATION BY TAX AUTHORITIES

The CRA is using its powers under the ITA to compel the delivery of both domestic and foreign-based information. Strategies used include questionnaires, requests for tax-planning memoranda and demands for emails. Failure to comply may result in the issuance of subpoenas known as "requirement letters" or a court application for a "compliance order." Litigation over the provision of such information is growing because taxpayers are resisting demands for voluminous information (including, in some cases, clearly irrelevant or privileged documents) to be provided within short time frames. As a sign of its strategic focus, the CRA is having Justice lawyers advise tax auditors on accessing information from taxpayers.

The CRA is also looking to its treaty partners for exchanges of information. The conclusion of a number of tax information exchange agreements between Canada and various jurisdictions, including "tax havens," will facilitate further recovery of information. On November 4, 2011, Canada entered into a *Convention on Mutual Administrative Assistance in Tax Matters*, which will require ratification by Parliament.

### NEED FOR STRATEGIC MANAGEMENT OF TAX CONTROVERSIES

In many tax disputes involving large amounts, particularly in the transfer pricing and "aggressive tax planning" areas, formal litigation in the Tax Court (which has exclusive original jurisdiction to hear federal income tax and Goods and Services Tax cases) is becoming acrimonious, much to the displeasure of some judges who have, on occasion, been openly critical of a perceived decline in co-operation between counsel and parties to the proceedings.

Taxpayers are looking for ways to avoid tax litigation through, for example, settlement conferences encouraged by the Tax Court or through attempts to resolve disputes at earlier stages of the tax controversy process (e.g., audit or administrative appeal stages). Statistics show that very few disputes are actually decided by the Tax Court relative to the number of disputes settled at earlier stages of the tax controversy process.

Domestically, alternative dispute resolution mechanisms such as arbitration and mediation have enjoyed little or no success. However, in the international arena where double tax is at issue, taxpayers are attempting to find resolution through either or both the Mutual Assistance Procedure (including arbitration when available) involving the Canadian Competent Authority and the conclusion of advance pricing agreements in transfer pricing matters.

### "AGGRESSIVE TAX PLANNING" – SOME CURRENT AUDIT INITIATIVES

The CRA has been scrutinizing international cross-border arrangements, including those involving foreign tax credit claims. Interprovincial tax-planning arrangements have also attracted challenges and have resulted in cases being decided by the provincial superior courts. Tax authorities have used the federal or provincial General Anti-Avoidance Rules (GAAR) as the primary or secondary ground of attack. Arrangements under attack include tax deferral using partnerships, tax sparing, foreign tax credit utilization, shifting of tax attributes or losses to arm's-length parties, leveraged donations and claims for "artificial" capital losses. Tax authorities are also relying on specific anti-avoidance rules as well as judicial concepts such as "sham" and "ineffective transaction" to deny tax benefits.

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## SOME RECENT JURISPRUDENCE

### Copthorne

#### Overview

On December 16, 2011, the Supreme Court of Canada (SCC) released its decision and reasons in *Copthorne Holdings Ltd. v. Canada (Copthorne)*. All nine of the judges of the SCC unanimously determined that the taxpayer's appeal should be dismissed as it had been in the two lower courts below. The decision thoroughly canvasses issues relating to the application and interpretation of the GAAR under the ITA.

The decision reinforces and consolidates principles enunciated in three earlier GAAR cases decided by the SCC (*Canada Trustco*, *Kaulius* and *Lipson*) and expresses both caution and direction about the future application of the GAAR by tax officials. In doing so, the SCC has also left readers of the decision with a number of impressions about the types of circumstances in which the GAAR should and should not be applied in future and the ability of taxpayers to arrange their affairs in order to minimize taxes payable.

Perhaps most striking in the reasons of the SCC are the comments about the appropriate methodology for the interpretation of taxing statutes and the unique methodology that is to be used when the GAAR is in play. The SCC openly admonished both the lower courts and readers of tax legislation (including the GAAR) 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." So it seems that judges are not to use a "smell test" or an interventionist approach when deciding tax cases. However, it remains to be seen whether this admonition will be heeded.

While the commentary and analysis of the SCC have both elements favourable to taxpayers and to the Crown, both sides must realize that it seems unlikely that the SCC will be open to granting leave in another GAAR case anytime soon given that the *Copthorne* reasons were written by Mr. Justice Rothstein. Justice Rothstein, one of the dissenting judges in *Lipson*, unanimously expressed the consolidation of earlier principles enunciated in *Canada Trustco* and the more fractured decision in *Lipson*. The SCC made it very clear that "[*Canada Trustco*] is a very recent decision" and that there must be "substantial reasons to believe the precedent was wrongly decided" in order for it to be revisited. To the extent that any points about the interpretation of GAAR issues are not addressed in *Copthorne*, one should presume that any applicable comments in *Canada Trustco* and the other two earlier SCC decisions will govern.

#### Impact of Copthorne

While *Copthorne* reaffirms through a unanimous bench how the SCC perceives the GAAR is to be interpreted, the decision may still not create more certainty, consistency or predictability for cases involving the GAAR than before its release.

What appeared to offend the SCC in *Copthorne* was the "double counting" of paid-up capital and its "artificial" preservation in a way that frustrated a statutory provision. Yet the SCC indicates that abuse determinations should not involve value judgments of what is right and wrong and theories about what the tax law ought to be. There is no doubt that the lower courts are being told to apply this message when deciding GAAR cases.

However, each judge's perception of the underlying rationale for a statutory provision may differ, particularly if there is little or no guidance from the statutory provisions. What may be clear to one person may not be to another. Nevertheless, lower courts are expected to consistently apply the words from Mr. Justice Rothstein's decision:

"...the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear"

"...the Minister must clearly demonstrate that the transaction is an abuse of the Act, and the benefit of the doubt is given to the taxpayer"

### Other Jurisprudence

In late 2010 to mid-2011, the SCC granted leave to appeal in a number of tax cases. These include *Glaxo*, the first transfer pricing case to reach this level, and *St. Michael Trust Corp.*, which involves the principles for determining the residence of a trust for income tax purposes. *Glaxo* was heard on January 13, 2012, and the decision was reserved; *St. Michael Trust* is scheduled for hearing on March 13, 2012.

*GE Capital Canada* is a transfer pricing decision of the Federal Court of Appeal (FCA) that upheld the taxpayer's ability to deduct a cross-border guarantee fee payable to a related party but suggested that "implicit support" is a factor to be considered in determining the creditworthiness of a subsidiary. The FCA's decision in *Daishowa* deals with the assumption of contingent liabilities for silviculture costs. The decision, adverse to the taxpayer, may significantly affect the calculation of proceeds of disposition from the sale of businesses/assets involving the assumption of contingent liabilities (e.g., reclamation, severance/pension obligations). Leave to appeal to the SCC has been sought. In *Bozzer*, the FCA provided a favourable interpretation for rules permitting waivers of interest, which may enable taxpayers to apply for discretionary relief to eliminate claims for arrears interest in broader circumstances.

Significant Tax Court decisions released in 2011 include *Alberta Printed Circuits* (transfer pricing), *4145356 Canada Limited* (foreign tax credits), *Potash Corporation* (deductibility of professional fees in an international reorganization) and three cases dealing with GAAR and the deductibility of losses: *Triad Gestco*, *1207192 Ontario*, and *Global Equity Fund*.

The Queen's Bench of Alberta, a provincial superior court, released two interesting decisions (*Husky*, *Canada Safeway*) which rebuffed attempts by the tax administration of Alberta to apply provincial GAAR legislation to tax planning designed to minimize or eliminate Alberta income tax.