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Tax Controversy 2023

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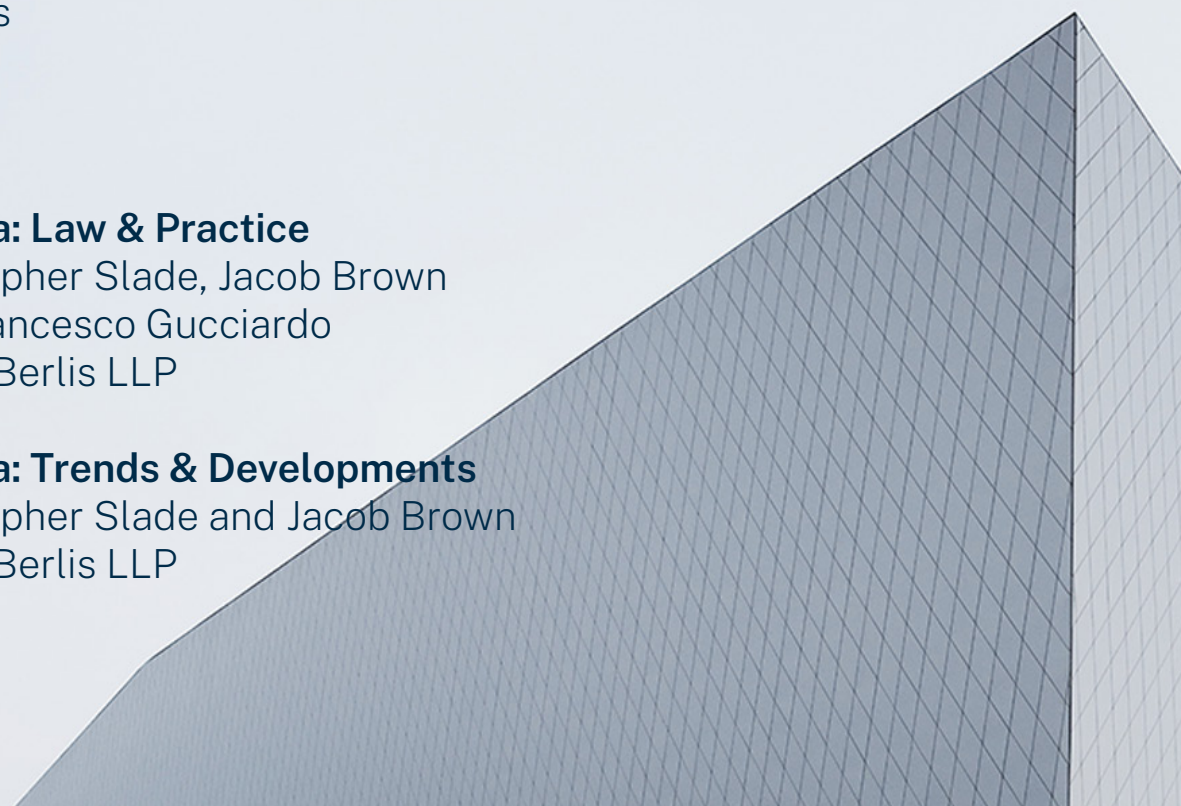

Canada: Law & Practice
Christopher Slade, Jacob Brown and Francesco Gucciardo
Aird & Berlis LLP

Canada: Trends & Developments
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CANADA

Law and Practice

Contributed by:
Christopher Slade, Jacob Brown and Francesco Gucciardo
Aird & Berlis LLP

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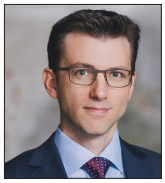
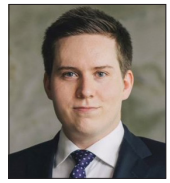
Aird & Berlis LLP is one of Canada's premier business law firms with strong recognition both nationally and internationally. Based in Toronto, the lawyers work closely with clients in Canada, the United States, the United Kingdom and around the world on matters involving Canadian law. The firm provides legal and strategic advice in all principal areas of business law, including corporate finance, taxation, banking, insolvency and restructuring, energy, environmental, infrastructure/P3, technology and intellectual property, commercial litigation, workplace law, municipal and land use planning, and real estate. Its tax group is highly regarded for transactional/advisory matters and features one of the largest tax litigation teams in the country.

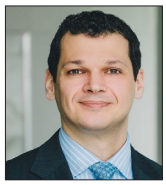
Authors



Christopher Slade of Aird & Berlis has extensive experience advising on domestic and international tax controversy and litigation matters. He has successfully represented a wide range of clients, including multinational corporations, financial institutions, pension funds and ultra high net worth individuals, and he routinely acts on high value and complex cases. Chris' strategic approach allows him to position his clients for effective negotiation with the tax authorities, with the objective of obtaining favourable results efficiently and avoiding litigation when possible. He has an exceptional track record, having successfully resolved most of his cases by consent judgment or at the administrative appeals level.



Jacob Brown of Aird & Berlis has experience assisting clients in all aspects of the tax dispute resolution process. Clients appreciate his sound judgment as well as his dedication to resolving disputes efficiently and, wherever possible, without litigation. Jacob's practice also includes advising and representing clients under audit, making disclosures under the Canada Revenue Agency's Voluntary Disclosures Program, challenging administrative action by the tax authorities and making requests for interest and penalty relief as well as other discretionary remedies.



Francesco Gucciardo of Aird & Berlis maintains a practice which focuses on corporate transactions for both public and private companies in the domestic and international sphere. His clients rely on his sophisticated knowledge of domestic and international tax to further their business objectives. Francesco stays current on emerging issues and proactively works to keep his clients informed of opportunities and potential challenges. He has extensive experience in areas of corporate mergers, acquisitions, reorganisations and divestitures, divisive reorganisations, structured finance, income funds, REITs, structuring Canadian inbound investment, private equity investment, structuring executive compensation plans, partnership agreements and joint ventures. Francesco currently serves as Vice-Chair of the Taxes Committee for the International Bar Association and Co-Chair of the Foreign Lawyers Forum for the American Bar Association. He is also a member of the firm's Executive Committee.

Aird & Berlis LLP

Brookfield Place
181 Bay Street
Suite 1800
Toronto
Canada
M5J 2T9

Tel: +416 863 1500
Email: airdberlis@airdberlis.com
Web: www.airdberlis.com

1. Tax Controversies

1.1 Tax Controversies in This Jurisdiction

Tax controversies in Canada most often arise after an audit, which generally involves a Canadian taxation authority examining the books and records of a taxpayer to confirm that tax liability has been correctly reported. In most cases, the taxation authority conducting the audit is the Canada Revenue Agency (CRA), which is responsible for administering Canada's federal income tax, most of Canada's provincial income taxes and also Canada's value-added tax known as the Goods and Services Tax/Harmonized Sales tax (GST/HST) in all provinces other than Québec. Alberta administers its own provincial corporate income tax and Québec administers its own provincial income tax system as well as its equivalent of the GST/HST (known as Québec Sales Tax or QST). British Columbia, Manitoba and Saskatchewan administer their own provincial sales taxes, which are traditional retail sales and use taxes (not value-added taxes).

In addition to tax controversies regarding tax liability, disputes also arise in relation to discretionary or other administrative action taken by Canada's taxation authorities.

1.2 Causes of Tax Controversies

Most Canadian tax controversies arise in the income tax context, and disputes in this area also tend to be the largest in terms of the amounts at issue. A wide range of issues has resulted in tax litigation, including:

- computation of profit;
- interest deductibility;
- corporate reorganisations and corporate control;
- capital versus income;
- transfer pricing;
- entitlement to benefits under Canada's tax treaties;
- the General Anti-Avoidance Rule (GAAR) and other anti-avoidance rules;
- administrative penalties; and
- entitlement to tax credits, including for scientific research and experimental development (SR&ED).

A significant number of disputes also arise in relation to the GST/HST. While tax controversies do occur in other contexts (eg, provincial sales tax, customs duties, etc), those account for a relatively small portion of total controversies, both in number and value.

With respect to discretionary decisions or actions taken by Canadian tax authorities in administering tax legislation, disputes can relate to a variety of matters including the scope of the CRA's audit powers, discretionary relief from interest and penalties, and the administration of special programmes such as the CRA's tax amnesty programme known as the Voluntary Disclosures Program.

1.3 Avoidance of Tax Controversies

The potential for tax controversy in Canada can be reduced by satisfying applicable compliance obligations and by reporting taxable income in a manner that is consistent with the applicable tax laws as well as the administrative positions taken by the Canadian tax authorities.

In recent years, Canadian tax authorities have been particularly focused on combating tax evasion and "aggressive tax avoidance", and amendments have recently been proposed that would broaden the scope of Canada's GAAR.

Other legislative proposals target cross-border tax planning strategies such as hybrid mismatch arrangements, where transactions give rise to a deduction in one jurisdiction without a corresponding income inclusion in the other. In general, transactions designed to minimise Canadian tax through creative structures that "push the limits" of the law are almost certain to attract greater scrutiny on audit.

Tax controversies in Canada also frequently arise due to incomplete or inaccurate books and records and as a result of miscommunications with the tax authorities.

Persons carrying on a business or engaged in a commercial activity in Canada are generally required to maintain books and records containing sufficient information to allow the determination of their tax liabilities and obligations. Taxpayers should therefore maintain a robust record-keeping system and, when undertaking significant transactions, should take steps to ensure all relevant documentation is preserved. To reduce the risk of miscommunication with the tax authorities, it is advisable to retain qualified Canadian tax counsel at the outset of an audit.

1.4 Efforts to Combat Tax Avoidance

Canada has adopted or has announced its intention to adopt a number of measures stemming from the OECD's Inclusive Framework initiative, including:

- country-by-country reporting rules;
- the OECD's multilateral convention (MLI) to implement tax treaty-related measures to prevent base erosion and profit shifting (BEPS);
- legislative proposals to address hybrid mismatch arrangements;
- legislative proposals to limit the deduction of excessive interest and financing expenses;
- legislative proposals to enact a digital services tax effective 1 January 2024 (in the event that a multilateral treaty implementing the Pillar One tax regime has not come into force); and
- a commitment to introduce legislation implementing the Pillar Two global minimum tax by way of a domestic minimum top-up tax and an undertaxed profits rule.

In addition, proposed legislation would expand the scope of the existing mandatory reporting/reportable transactions regime and introduce new requirements to report notifiable transactions and uncertain tax treatments and positions. It is too early to assess the extent to which these legislative developments will contribute to an increase or reduction in tax controversy in Canada.

1.5 Additional Tax Assessments

Where an assessment of Canadian federal or provincial tax has been made by the tax authorities, taxpayers should consider (i) their obligation to pay any outstanding tax, interest or penalties, and (ii) their right to contest the assessment. In Canada, these matters are generally distinct – there is no concept of "pay to play".

Any balance owing as a result of a notice of assessment or reassessment issued under either the federal Income Tax Act (ITA) or Part IX of the federal Excise Tax Act (ETA), which governs the GST/HST, is payable forthwith. However, various rules can apply to limit the powers of the Canadian tax authorities to collect, depending on the type of taxpayer and the nature of the balance. For example, collection powers are generally suspended if the taxpayer contests the assessment by filing a notice of objection (see **3. Administrative Litigation**). However, if the taxpayer is a "large corporation" (where the

"taxable capital employed in Canada" of the corporation and all related corporations is greater than CAD10 million), special rules permit the collection of 50% of the amount in controversy. Certain types of balances, including amounts withheld from employee payroll, GST/HST and non-resident withholding taxes, are collectible without restriction.

Canadian tax authorities generally have the discretion to accept security for payment and may also agree to payment arrangements or defer collection action entirely in appropriate cases. Where security is proposed, the CRA will normally request a letter of guarantee or standby letter of credit issued by a Canadian bank or a subsidiary of a foreign bank operating in Canada. Acceptability of other forms of security is determined on a case-by-case basis.

Where a balance resulting from an assessment has not been paid, arrears interest will continue to accrue. Canadian tax laws do not generally provide for the imposition of additional penalties for the failure to pay an outstanding balance. However, in the absence of a payment arrangement or the provision of acceptable security, the CRA may take various actions to collect amounts owed, including garnishing income or bank accounts, asset liens, seizures, and third-party assessments.

2. Tax Audits

2.1 Main Rules Determining Tax Audits

The CRA generally employs risk-assessment systems to identify tax returns for audit. The risk assessment can take various factors into account, such as past compliance history, business complexity and information obtained from auditing or investigating other taxpayers. Taxpayers can also be selected for audit randomly.

It is understood that the CRA is increasingly developing and relying on advanced analytics and predictive models in the identification of non-compliance. The CRA has stated that these models use machine-learning techniques to identify potential areas of non-compliance by discovering unseen patterns in data. One example of this is the CRA's Integrated Risk Assessment System (IRAS), which analyses taxpayer information from CRA databases and applies sophisticated algorithms to assess the risk of tax non-compliance of large businesses. The CRA has also stated that it is implementing "social network analysis" to automate the identification of links between individuals and businesses.

2.2 Initiation and Duration of a Tax Audit

The CRA may initiate an audit at any time and there is no limit on how long an audit may last. However, the duration of an audit is generally limited in practice by an applicable limitation period for reassessment.

Under the ITA, the statutory limitation period for reassessments (referred to as the "normal reassessment period") begins when the initial "notice of assessment" for a particular taxation year is issued and runs for the following three or four years, depending on the type of taxpayer. This period may be extended by an additional three years in certain circumstances, such as where an assessment relates to a transaction with a non-arm's length non-resident person. However, there is no limitation period for certain types of assessments (eg, non-resident withholding tax), and reassessments can be made after the expiration of the normal reassessment period where there has been a misrepresentation attributable to neglect, carelessness or wilful default.

A taxpayer may also voluntarily waive the normal reassessment period. Similar rules apply to GST/HST assessments made under Part IX of the ETA.

2.3 Location and Procedure of Tax Audits

Audits are generally commenced by the CRA's Compliance Programs Branch (CRA Audit) sending a letter informing the taxpayer that particular taxation years have been selected for audit and requesting the production of relevant information and documents. Prior to the COVID-19 pandemic, it was more common for CRA auditors to visit taxpayers' premises and spend significant time there reviewing records. In recent years, most CRA auditors have conducted their reviews remotely. However, the CRA has recently announced plans to reinstate audits on site.

Taxpayers are generally permitted to provide information and documents in print or electronic form. However, some CRA auditors will require that taxpayers provide documents in a particular form, and the CRA is increasingly encouraging taxpayers to provide information and documents digitally.

The CRA has extremely broad audit powers and may require production of any non-privileged domestic or foreign-based information and documents within the taxpayer's possession or control, including documents relevant to taxation years outside the identified audit period. Recent legislative amendments stipulate that the CRA can require taxpayers to answer "all proper questions" and provide "all reasonable assistance" for any purpose relating to the administration or enforcement of the ITA, including by submitting to oral questioning at any place designated by the CRA. A detailed review of the CRA's audit powers and their limits is beyond the scope of this guide.

2.4 Areas of Special Attention in Tax Audits

In recent years, heightened audit activity has been observed in the following areas:

- compliance with Canada's foreign reporting requirements;
- aggressive tax avoidance and tax evasion using offshore entities;
- transfer pricing and cross-border financing;
- benefits under Canada's tax treaties;
- transactions involving cryptocurrency;
- tax scheme promoters;
- high net worth individuals and their related entities;
- aggressive GST/HST planning involving refund and rebate claims (and suspected "carousel" fraud); and
- benefits provided under COVID-19 programs, including in particular the Canada Emergency Wage Subsidy.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance Between Tax Authorities on Tax Audits

Canada's tax treaties generally provide that the competent authorities of the contracting states shall exchange information relevant to carrying out the treaty or to the administration or enforcement of Canada's domestic tax laws. While it is difficult to be certain, increased co-operation between Canada and other jurisdictions appears to have had a corresponding impact on the frequency and effectiveness of CRA audit activity relating to foreign assets and offshore transactions. Notably, a request by the CRA for assistance from the Swiss tax authorities was recently the subject of unsuccessful challenges in both

Canada and Switzerland (see Levett v Canada (Attorney General), 2022 FCA 117).

2.6 Strategic Points for Consideration During Tax Audits

In general, consideration should be given to the following points:

- the involvement of outside tax counsel and other tax advisers;
- determining who will be the main point of contact with the auditor;
- where, when and how the audit will be conducted;
- optimising the presentation of facts and issues, with a view to controlling the record and minimising the risk of unfavourable adjustments or expansion of the scope of the audit;
- managing the extent of CRA requests for information and documents and determining whether and when to challenge such requests;
- the provision of waivers;
- circumstances involving referrals to other branches of the CRA (eg, the Income Tax Rulings Directorate or the Transfer Pricing Review Committee); and
- consequential impacts of proposed adjustments on other taxation years.

3. Administrative Litigation

3.1 Administrative Claim Phase

Notices of Assessment, Reassessment and Objection

The CRA will generally assess the tax payable for a taxation year shortly after the taxpayer files their return for the year, and will send the taxpayer a "notice of assessment". This initial assessment usually reflects the information reported in the taxpayer's return. If the CRA later audits the taxpayer and makes adjustments that impact tax liability, the CRA will reassess the tax payable for the taxation year and send a "notice of reassessment".

Taxpayers wishing to contest an assessment or reassessment are required to serve the CRA with a "notice of objection" addressed to the "Chief of Appeals". Notices of objection are generally required to set out the reasons for the objection and all relevant facts, and may be filed by delivering or mailing a copy to a CRA Tax Services Office or Tax Centre, or through the CRA's online My Account and My Business Account services (as applicable).

Additional Rules Applicable to Large Corporations

If the taxpayer is a "large corporation" (where the "taxable capital employed in Canada" of the corporation and all related corporations is greater than CAD10 million), the notice of objection must (i) reasonably describe each issue to be decided; (ii) specify in respect of each issue the relief sought expressed as the amount of a change in a balance; and (iii) provide facts and reasons relied on by the corporation in respect of each issue. The failure of a large corporation to raise a specific issue and request corresponding relief can result in the corporation being precluded from raising the issue or obtaining relief in a subsequent judicial appeal. These rules have frequently been the subject of litigation, and large corporations are therefore well advised to consult with qualified Canadian tax advisers when filing notices of objection.

Deadline to object and extensions of time

A notice of objection must generally be filed within 90 days of the sending of the relevant notice of (re)assessment.

If a taxpayer fails to object within the 90-day period and not more than one year has passed since the expiration of that period, the taxpayer may apply to the CRA for an extension of time to object. To be considered valid, an application for an extension of time must set out the reasons why the notice of objection was not filed within the normal time period, and demonstrate that the taxpayer made the application as soon as circumstances permitted and that, within the normal time period, the taxpayer either (i) was unable to act or instruct another to act in their name, or (ii) had a bona fide intention to object to the assessment.

If the CRA refuses to grant an extension of time to object, the taxpayer has the right to appeal the refusal to the Tax Court of Canada (the "Tax Court").

3.2 Deadline for Administrative Claims

Notices of objection are considered by the CRA's Appeals Branch ("CRA Appeals"), which is a division of the CRA separate from CRA Audit. As of March 2023, the CRA has reported that medium complexity income tax cases were being completed in an average of 302 days and that high complexity cases may take over 690 days.

While filing a notice of objection is a mandatory step in the dispute resolution process, taxpayers are not obligated to conclude the administrative appeals process before commencing a judicial appeal to the Tax Court.

4. Judicial Litigation: First Instance

4.1 Initiation of Judicial Tax Litigation

To initiate an appeal to the Tax Court, the taxpayer must file a "notice of appeal" that sets out the details of the assessment under appeal, the material facts relied upon, the issues to be decided, the statutory provisions and reasons relied upon and the relief sought, and pay a filing fee.

Proceedings in the Tax Court may be initiated where the CRA has considered a taxpayer's objection and confirmed the disputed (re) assessment or has issued a new reassessment. Taxpayers also have the right to terminate the administrative appeals process and appeal directly to the Tax Court where a notice of objection has been filed and 90 days have elapsed without the CRA having made a decision. The latter approach may be appropriate where, for example, the assessment under objection reflects the CRA's institutional policy with respect to the interpretation of a particular provision, and the administrative appeals process is therefore unlikely to result in a satisfactory resolution.

A notice of appeal must generally be filed within 90 days of the CRA issuing a notice of confirmation or reassessment. If a taxpayer fails to appeal within the 90-day period and not more than one year has passed since the expiration of that period, the taxpayer may apply to the Tax Court for an extension of time. In order for such an application to be granted, the taxpayer must generally satisfy the same criteria that apply to an application for an extension of time to object (see **3.1 Administrative Claim Phase**).

4.2 Procedure of Judicial Tax Litigation

Appeals in the Tax Court may be governed by either the Informal Procedure rules or the General Procedure rules. For income tax appeals, the Informal Procedure is limited to cases in which the amount of federal tax and penalties in dispute for each taxation year, excluding interest, is CAD25,000 or less and to cases in which

the amount of a loss in question is CAD50,000 or less.

The following discussion, which generally pertains to appeals under the General Procedure, is intended to be summary in nature and does not address interlocutory steps such as status hearings, motions and case management conferences. This guide also does not address the procedure for challenging discretionary decisions or other administrative action taken by the Canadian tax authorities.

Upon receipt of the notice of appeal and a filing fee, the Tax Court will serve the notice of appeal on the opposing party (the "respondent"). Formally, the respondent is Canada's head of state, King Charles III, as represented by the Attorney General of Canada. In practice, the respondent is represented by one or more lawyers from Canada's Department of Justice ("DOJ Counsel"), who are instructed by a CRA litigation officer.

After service of the notice of appeal, the respondent has 60 days in which to file a reply to the notice of appeal. In the reply, the respondent is required to state whether the respondent admits, denies or has no knowledge of each fact pleaded in the notice of appeal. The respondent must also set out the assumptions of fact made by the CRA in assessing the taxpayer and any additional facts relied upon.

After a reply has been served, the taxpayer has 30 days in which to file an optional pleading referred to as an "answer".

Discovery Phase

The second phase of a Tax Court appeal is the "discovery phase" and has two components: documentary discovery and examinations for discovery.

Documentary discovery involves the service and filing of a list of documents, and the production of those documents to the other party. By default, it is only necessary to include those documents that the party might use in evidence, either in establishing the party's own case or rebutting the opposing party's case. However, either party may apply to the court for an order directing full disclosure of all documents relevant to any matter in issue.

Examination for discovery will generally involve the oral examination of the taxpayer (where the appellant is an individual) or a nominee (where the appellant is a corporation, trust or partnership). The nominee for the respondent is in most cases the auditor who recommended the adjustment(s) in dispute or the appeals officer who confirmed the disputed assessment.

Prior to the COVID-19 pandemic, oral examinations were generally held in person. During 2020, 2021 and 2022, many examinations were instead conducted virtually via platforms such as Zoom or Microsoft Teams. As the intensity of the pandemic has waned, examinations have frequently been conducted in a hybrid format, where some participants attend in person and others attend virtually. Examinations for discovery may also be conducted in writing, but this is less common.

Examinations are often extensive and can range in length from half a day to several weeks. Where the answers to questions are initially not known or additional production of documents is requested, counsel may undertake to provide a response at a later time in writing, which will usually lead to additional follow-up questions. This process generally unfolds over several months and is ordinarily governed by a timetable order issued by the court.

Settlement Conferences

Following the completion of the discovery phase, either party may request a settlement conference moderated by a judge of the court.

A settlement conference is an off-the-record meeting in which the parties have the opportunity to present their arguments in summary form and receive a judge's perspective on the merits of their respective positions. In the event that the appeal does not settle, the judge that presided over the settlement conference cannot preside over the hearing.

Where a settlement conference is scheduled, each party is required to file a "settlement conference brief" that summarises the party's case, including their theory of the case and the manner in which material facts will be proven. The format of the settlement conference itself is at the discretion of the presiding judge, who may consult with the parties as to their preferences.

Hearing and Decision

A Tax Court hearing takes place before a single judge assigned by the Chief Justice of the court. In most cases, the taxpayer bears the burden of proof and will present their case first.

Counsel will generally begin with a brief opening statement, and will then proceed to call their witnesses (if any). Each witness called by taxpayer's counsel will be examined first by the taxpayer's counsel (the "examination-in-chief") and then by DOJ counsel (the "cross-examination"). Witnesses may include individuals with direct knowledge of events at issue as well as expert witnesses. A party calling an expert witness must, among other things, serve an "expert report" on the other party at least 90 days before the hearing. Following the presentation of the taxpayer's case, including documentary evidence relied upon, DOJ counsel will present the government's case in the same manner. Counsel for each party will then have the opportunity to present legal arguments.

At the end of the hearing, the judge will either deliver their decision orally or, in most cases, reserve the decision to be rendered later in writing. There is no time limit for a decision to be rendered, but in a typical case the decision will be released within approximately three to nine months.

4.3 Relevance of Evidence in Judicial Tax Litigation

See **4.2 Procedure of Judicial Tax Litigation**.

4.4 Burden of Proof in Judicial Tax Litigation

The taxpayer generally bears the burden of proof in civil tax litigation proceedings in Canada. In particular, the taxpayer has the burden of establishing, on a balance of probabilities, each material fact stated in the notice of appeal. In addition, assumptions of fact made by the CRA in assessing the taxpayer or in confirming an assessment are presumed to be true unless the taxpayer can either disprove them or establish that they were not in fact made by the CRA.

The respondent will have the burden of establishing the material facts necessary to support a reassessment made after the expiration of the normal reassessment period or to justify the imposition of certain penalties, including gross negligence penalties. The respondent also has the burden of proving any additional facts alleged in the reply that were not assumed by the CRA.

4.5 Strategic Options in Judicial Tax Litigation

Throughout the Tax Court process, taxpayers and their counsel will be presented with opportunities to make strategic decisions that may significantly affect the trajectory of the appeal. These will generally include:

- how to present material facts, issues and reasons in the notice of appeal;
- the appropriate nominee to be examined for discovery;
- during the examination for discovery, the extent to which it is appropriate to limit DOJ counsel's questions and the manner in which to examine the respondent's nominee;
- whether and when to bring motions (eg, where the respondent's pleadings or responses to discovery questions are deficient);
- whether and when to actively pursue settlement discussions, extend a settlement offer, disclose legal analysis in an effort to encourage settlement, or request a settlement conference;
- which witnesses should be called to testify at the hearing, including whether to call one or more expert witnesses; and
- which legal authorities should be relied upon at the hearing, and how they should be presented to the court.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Canadian courts are bound by applicable Canadian statutes and regulations, treaties to which Canada is party, and the jurisprudence of higher Canadian courts. In the case of the Tax Court, these higher courts are the Federal Court of Appeal (FCA) and the Supreme Court of Canada (Supreme Court). Each of these courts will generally follow their own precedents, but has the authority to depart from them when they consider it appropriate to do so. Jurisprudence of international courts and courts of other jurisdictions, secondary sources (eg, academic articles), government documents (eg, CRA publications) and international guidelines (eg, the OECD's Transfer Pricing Guidelines) may be considered persuasive but are generally not binding. Notwithstanding this, we note the ITA provides that certain provisions be interpreted consistently with international guidelines (eg, subsection 270(2)).

5. Judicial Litigation: Appeals

5.1 System for Appealing Judicial Tax Litigation

Decisions of the Tax Court may be appealed to the FCA as of right. Decisions of the FCA may be appealed to the Supreme Court if the Supreme Court grants leave (ie, permission) to do so. Since the SCC grants applications for leave to appeal in very few taxation cases, the FCA is most often the court of last resort for Canadian tax disputes.

5.2 Stages in the Tax Appeal Procedure

A party may appeal to the FCA by filing a notice of appeal within ten days (in the case of an interlocutory judgment) or 30 days (in all other cases) of the relevant decision of the Tax Court. The 30-day time limit does not include any days in July and August. The notice of appeal must include, among other things, a statement of the relief sought and the grounds intended to be argued.

The FCA will only allow a party to present new evidence in special circumstances (eg, where the evidence could not have been adduced at trial with the exercise of due diligence and meets certain other requirements). Where the appellant

alleges that the lower court erred in answering a question of fact or of mixed fact and law (eg, determining whether a particular legal test was satisfied in a specific situation), the appeal will only be successful if the FCA determines that the lower court made a palpable and overriding error. On the other hand, where the appellant alleges the lower court made an error of law (eg, applying the wrong legal test), the FCA will determine the appeal on the standard of correctness.

Before the FCA schedules a hearing, each party must file a memorandum of fact and law containing (i) a concise statement of fact; (ii) a statement of the points in issue; (iii) a concise statement of submissions; (iv) a concise statement of the order sought, including any order concerning costs; and (v) a list of the authorities to be referred to.

An FCA hearing takes place before a panel of three judges selected by the FCA's Chief Justice and is typically scheduled to last between two and four hours. Each side is given an opportunity to orally argue their case and to answer questions from the court. At the conclusion of the hearing, the court will either deliver the decision orally or, in most cases, reserve the decision to be rendered later in writing.

A party wishing to appeal a decision of the FCA to the SCC must file an application for leave to appeal within 60 days of the date of the FCA's judgment. The application must include, among other things, a memorandum of fact and law. Applications for leave to appeal will only be granted where the court is of the opinion that the matter deals with issues of law that are of public importance or of such a nature or significance as to warrant a decision by the court.

An SCC hearing will typically be heard by at least seven of the court's nine judges. The specific composition of the panel is determined by the SCC's Chief Justice. At the conclusion of a hearing, the SCC may render its decision orally or may reserve its decision to be issued in writing. Where a decision is reserved, the SCC's written reasons are released on average six months after the hearing.

5.3 Judges and Decisions in Tax Appeals

See **5.2 Stages in the Tax Appeal Procedure**.

6. Alternative Dispute Resolution (ADR) Mechanisms

6.1 Mechanisms for Tax-Related ADR in This Jurisdiction

Canada does not currently have any formal alternative dispute resolution mechanisms for domestic tax disputes.

6.2 Settlement of Tax Disputes by Means of ADR

There is no applicable information in this jurisdiction.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Canada's Minister of National Revenue (the Minister) has broad statutory discretion to waive or cancel interest and penalties arising under the ITA or in relation to GST/HST. The CRA's published administrative position is that this discretion will normally only be exercised in "extraordinary circumstances" (eg, where there is an inability to pay or financial hardship, or the interest/penalties arose due to delay or other actions of the CRA). The Minister's discretion to grant relief is limited to any period that ended within ten years

before the calendar year in which a request is submitted or an income tax return is filed.

The CRA also operates a Voluntary Disclosures Program, under which the Minister grants relief on a case-by-case basis to taxpayers who voluntarily come forward to correct errors or omissions in their tax filings. In exceptional circumstances, it is also possible obtain a remission order under Canada's Financial Administration Act, which can provide relief from any tax, interest, penalties or other debt paid or payable under legislation administered by the CRA.

A detailed review of the circumstances in which discretionary relief is available under the ITA and Part IX of the ETA is beyond the scope of this guide.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Taxpayers may seek to avoid income tax disputes by requesting either an income tax technical interpretation or an advance income tax ruling from the CRA. Similar services are also available with respect to GST/HST questions arising under Part IX of the ETA.

A technical interpretation is generic in nature and provides the CRA's interpretation of specific provisions of the legislation. It is not intended to be determinative of the tax consequences to a particular taxpayer.

In contrast to a technical interpretation, a ruling is a written statement that confirms how the CRA's interpretation of specific provisions applies to a definite transaction or series of transactions contemplated by a taxpayer. A ruling is generally regarded as binding on the CRA with respect to the recipient taxpayer and the described transactions to the extent that there is no material omission or misrepresentation in the statement of relevant facts, proposed transactions or other information described in the ruling.

Disputes have arisen in cases where issues that were outside the scope of the ruling are subsequently raised by the CRA on audit. It should also be noted that rulings are administrative in nature and are not legally binding. While rare, there may be circumstances where the CRA might seek to resile from a ruling. It can also frequently take significantly longer than the CRA's published service standard of 90 days to obtain a ruling, particularly in complex cases.

The CRA will not issue either a technical interpretation or a ruling where the request relates to a matter that is under audit, under objection or the subject of a current or completed court process. It is generally advisable to seek assistance from counsel or other tax professionals in requesting a technical interpretation or ruling.

6.5 Further Particulars Concerning Tax ADR Mechanisms

There is no applicable information in this jurisdiction.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

There is no applicable information in this jurisdiction.

7. Administrative and Criminal Tax Offences

7.1 Interaction of Tax Assessments With Tax Infringements

Both the ITA and Part IX of the ETA provide for administrative penalties, which are strictly mone-

tary in nature and are assessed by CRA auditors in the same way as additional tax liability. Circumstances in which penalties may be imposed include, among other things, where a taxpayer has failed to file a return as and when required or has knowingly, or under circumstances amounting to gross negligence, made a false statement or omission in a return or other document. The fact that the CRA disagrees with the manner in which the taxpayer computed their tax payable is, by itself, currently not sufficient to assess a penalty, nor is the fact that the GAAR or a specific anti-avoidance rule applies to transactions undertaken by the taxpayer.

A taxpayer wishing to challenge an assessment of an administrative penalty must follow the same procedure that is used to challenge an assessment of tax (see **3. Administrative Litigation** and **4. Judicial Litigation: First Instance**).

7.2 Relationship Between Administrative and Criminal Processes

Where the taxpayer's misconduct is more serious, they may be investigated and charged with a criminal offence and, if convicted, may be liable to fines or imprisonment. The most serious tax offences are commonly described as "tax evasion" and include:

- participating in, assenting to or acquiescing in the making of false or deceptive statements in a return, certificate, statement or answer;
- destroying, altering, mutilating, secreting or otherwise disposing of the records or books of account of a taxpayer to evade payment of a tax;
- making, assenting to or acquiescing in the making of false or deceptive entries in records or books of account of a taxpayer;
- wilfully, in any manner, evading or attempted to evade compliance with the ITA/ETA or payment of taxes imposed by the ITA/ETA; or
- conspiring with any person to do one of the things described above.

In order for a person to be convicted of a tax evasion offence, the prosecution must prove beyond a reasonable doubt all of the elements of the alleged offence, including that the person had the necessary criminal intent. In contrast, where a person is charged with one of the less serious criminal offences provided for in the ITA/ETA (eg, failing to file a return as and when required and other "strict liability" offences), it is unnecessary to prove criminal intent. A person charged with a strict liability offence may nonetheless avoid liability if they can establish that they were duly diligent. In certain cases, prosecutors may instead charge a taxpayer with fraud or another offence set out in Canada's Criminal Code.

The less serious criminal tax offences may only be prosecuted as "summary offences", which carry a lighter penalty and are tried in the provincial courts before a judge alone. Tax evasion offences are summary offences by default, but at the option of the prosecutor may be upgraded to an "indictable offence", which carries more serious potential penalties and entails a more complex judicial procedure (eg, the possibility of a trial by jury).

Criminal tax investigations are generally handled by officers of the CRA's Criminal Investigations Division ("CRA Investigations"). An investigation may be initiated as a result of a referral from CRA Audit or as a result of a lead originating from another source. When the predominant purpose of a CRA inquiry becomes investigation for purposes of prosecution rather than assessment of

tax and administrative penalties, the taxpayer's rights under the Canadian Charter of Rights and Freedoms are engaged and the CRA is prohibited from using its ordinary civil audit powers. Because of this, if CRA Investigations wishes to perform a search of the taxpayer's property, it must first obtain the proper legal authorisation (eg, a search warrant). Similarly, if CRA Investigations wishes to interview the taxpayer under investigation, they must advise the taxpayer of their constitutional right not to self-incriminate. If CRA Investigations does not follow the proper procedures, any evidence obtained may be inadmissible in court.

Where taxability is relevant to the offence (eg, in a tax evasion case), Canadian courts have held that the taxability must be clear, obvious and indisputable because a criminal court is not the forum for such an issue to be determined. Accordingly, it is rare for charges to be brought in a case where there is any likelihood of a dispute regarding whether tax was owed.

7.3 Initiation of Administrative Processes and Criminal Cases

If CRA Investigations concludes that prosecution is warranted, the matter will be referred to the Public Prosecution Service of Canada (PPSC), the federal agency that prosecutes cases under federal statutes. If the PPSC prosecutor is satisfied there is a reasonable prospect of a conviction and it would be in the public interest to prosecute, the PPSC will lay charges in the appropriate provincial court or provincial superior court. At this point, the prosecution of a tax offence generally resembles that of any other criminal offence and the accused person would generally be well advised to retain a criminal lawyer, preferably one with experience in defending against tax-related charges.

7.4 Stages of Administrative Processes and Criminal Cases

Criminal offences are tried in Canada's provincial courts or provincial superior courts.

If a person is convicted of a summary offence by a provincial court and wishes to challenge the conviction or sentence, they may appeal to the relevant provincial superior court. A person convicted of an indictable offence by a provincial superior court would appeal instead to the relevant provincial court of appeal. In the event the person's appeal is dismissed, the person would appeal to the next level of court (ie, the relevant provincial court of appeal or the Supreme Court).

If a person is acquitted of a criminal offence or is believed to have received an insufficient sentence, the prosecution may also, in certain circumstances, appeal the decision. However, their right to do so is much more restricted.

7.5 Possibility of Fine Reductions

A person charged with a tax offence does not have an automatic right to reduce any potential fines by making payment of taxes owing. However, promptly and voluntarily paying all taxes, administrative penalties and interest owed may be viewed favourably by the court in deciding what sentence to impose.

Prior to charges being laid, it is common for the PPSC to offer an "early resolution" of the matter in order to avoid the time and expense of a trial. Such an offer may include a proposal that the taxpayer plead guilty to certain charges in exchange for other charges being dropped or a recommendation that a lighter-than-normal sentence be imposed.

7.6 Possibility of Agreements to Prevent Trial

See **7.5 Possibility of Fine Reductions**.

7.7 Appeals Against Criminal Tax Decisions

See **7.4 Stages of Administrative Processes and Criminal Cases**.

7.8 Rules Challenging Transactions and Operations in This Jurisdiction

At present, transactions that have been challenged in Canada under the GAAR or under a specific anti-avoidance rule have not given rise to administrative or criminal tax cases. With respect to transfer pricing, penalties may apply where the taxpayer has not complied with certain rules regarding contemporaneous documentation and the provision of such documentation to the CRA when requested.

8. Cross-Border Tax Disputes

8.1 Mechanisms to Deal With Double Taxation

Canada has adopted the minimum standards in the MLI for resolving treaty-related disputes, requiring it to implement a mutual agreement procedure (MAP) under which the competent authorities of each jurisdiction are required to attempt to resolve disputes within three years of notification. Additionally, Canada has opted into the mandatory arbitration procedures under the MLI, such that the "final offer" arbitration process operates as the default mechanism for addressing double taxation.

Where competent authority relief is requested under the MAP of an applicable treaty, taxpayers are responsible for taking steps to prevent affected taxation years affected from becoming statute-barred under the ITA. This can be accomplished either by filing waivers or, more often, by filing a notice of objection on a protective basis. For additional information in this regard, see **3. Administrative Litigation**.

In its published administrative guidance, the CRA has indicated that it will not consider certain cases for negotiation, including cases involving notional income adjustments, thin capitalisation or where the underlying assessment relies on a domestic anti-avoidance provision. In any circumstances where the CRA may decide not to entertain a request under the MAP, taxpayers may opt to instead challenge the assessment solely under Canada's domestic litigation process. Notably, the CRA's conduct in relation to its obligations under Canada's treaties has resulted in administrative law challenges in several cases.

Provided that the taxpayer has filed a notice of objection, the taxpayer retains the right of appeal to the Tax Court in the event that the competent authorities do not resolve the issues or the taxpayer decides to reject a competent authority agreement. However, taxpayers are administratively not permitted to proceed with either a notice of objection or an appeal to the Tax Court while the matter is under competent authority consideration.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Canada's domestic GAAR has applied explicitly to Canada's tax treaties since at least 2005 and arguably since the advent of the GAAR in 1988. Nonetheless, one might expect that the principal purpose test (PPT) introduced by the MLI, coupled with the amended preamble to covered tax agreements, will have an impact on the way Canadian tax authorities and courts

approach cases involving BEPS in cross-border situations.

Canada's domestic GAAR applies to deny a tax benefit in an associated avoidance transaction where it may reasonably be considered that the transaction would result directly or indirectly in a misuse of the provisions of the domestic legislation or tax treaty, or an abuse having regard to those provisions read as a whole. The PPT, on the other hand, provides that a benefit under a covered tax agreement shall not be granted if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction, unless it is established that granting the benefit in these circumstances would be in accordance with the object and purposes of the relevant provisions of the covered tax agreement. The difference between the GAAR and PPT is subtle but potentially significant, in that the GAAR places the burden of establishing a misuse or abuse on the Government of Canada, whereas the PPT appears to place the burden on the taxpayer to establish that obtaining the benefit aligns with the object and purposes of the relevant provisions.

The CRA has not indicated when and how it will apply the PPT, or whether it will favour the PPT over the GAAR (or vice versa).

8.3 Challenges to International Transfer Pricing Adjustments

In Canada, the vast majority of transfer pricing disputes are resolved through the MAP under Canada's existing tax treaties. A relatively small number of cases have been resolved through the domestic litigation process.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Canada has a well-established Advance Pricing Agreement (APA) programme, which is administered by the Competent Authority Services Division of the CRA. The objective of the APA programme is to assist taxpayers in preventing transfer pricing disputes by negotiating bilateral APAs or multilateral APAs that govern the determination of business profits in Canada from cross-border intercompany transactions. While unilateral APAs can be obtained, they are generally not preferred due to the potential for double taxation.

The process for obtaining an APA in Canada includes the following stages:

- pre-filing meetings;
- the APA request;
- the acceptance letter;
- the APA submission;
- preliminary review of the APA submission and establishment of a case plan;
- review, analysis and evaluation by the CRA;
- government-to-government negotiations;
- finalising the agreement;
- the post-settlement meeting; and
- APA compliance.

Although Canada's APA programme is well established, the time and costs involved in pursuing an APA generally mean that the programme will normally only be accessed by large multinationals that are frequently subject to Canadian transfer pricing audits. Notably, for 2021 (the most recent year for which statistics are publicly available), the CRA reported only 30 applicants to the programme, nine completed cases and a closing inventory of 66 active cases in progress. The CRA also reported that the average time to complete a bilateral APA

was 49.4 months, up from 36.9 months in 2020. The significant time required means that many agreements are implemented at least partly on a retroactive basis.

The CRA also administers a "Small Business APA Program" designed to reduce the time and cost of the traditional APA process described above. However, only unilateral APAs without rollback are available under that programme.

8.5 Litigation Relating to Cross-Border Situations

Canadian tax litigation in cross-border situations can arise in relation to disputes involving transfer pricing and related issues regarding the assessment of withholding tax on cross-border transactions. Recent decisions, including the decision of the FCA in Canada v Cameco Corporation, 2020 FCA 112, have involved the interpretation and application of the re-characterisation rules in paragraphs 247(2)(b) and (d) of the ITA. Those rules provide a mechanism for the Minister to determine arm's-length prices based on substituted transactions in circumstances where (i) a transaction or series of transactions would not have been entered into between persons dealing at arm's length; and (ii) it can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit. A number of cases involving the application of these rules to hybrid cross-border financing arrangements are currently pending in the Tax Court.

In addition to transfer pricing, cross-border situations have also generated tax controversy in relation to treaty shopping (see **8.2 Application of GAAR/SAAR to Cross-Border Situations**), beneficial ownership for purposes of Canada's tax treaties (L.F. Management and Investment SARL, Tax Court file no. 2018-388(IT)G), and Canada's regime for taxing income earned by foreign affiliates of Canadian companies (Canada v Loblaw Financial Holdings Inc., 2021 SCC 51). Significant disputes have also arisen in relation to the scope of the CRA's audit powers relating to foreign-based information (see **2.5 Impact of Rules Concerning Cross-Border Exchanges**) and Canada's foreign reporting requirements.

9. State Aid Disputes

9.1 State Aid Disputes Involving Taxes

There is no applicable information in this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

There is no applicable information in this jurisdiction.

9.3 Challenges by Taxpayers

There is no applicable information in this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

There is no applicable information in this jurisdiction.

10. International Tax Arbitration Options and Procedures

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

As at 16 December 2022, Canada's competent authority had settled the mode of application of the provisions contained in Part VI of the MLI with the competent authorities of 22 other countries, including most EU jurisdictions. The "final offer"

arbitration process (otherwise known as "last best offer" or "baseball" arbitration) will apply as the default type of arbitration process to Canada's covered tax agreements. Canada reserved the right not to apply independent opinion arbitration. In cases where one of its treaty partners to a covered tax agreement reserves the right not to apply final offer arbitration, Canada and its treaty partner will endeavour, in accordance with Article 23(3) of the MLI, to reach an agreement on the type of arbitration process that will apply. In these cases, Article 19 will not apply between Canada and the treaty partner until such agreement is in place.

10.2 Types of Matters That Can Be Submitted to Arbitration

Canada reserved the right to limit the scope of issues eligible for arbitration under the MLI to the following:

- issues arising under provisions akin to Article 4 (Resident) of the OECD Model Tax Convention (the "OECD Model"), but only insofar as the issue relates to the residence of an individual;
- issues arising under provisions akin to Article 5 (Permanent Establishment) of the OECD Model;
- issues arising under provisions akin to Article 7 (Business Profits) of the OECD Model;
- issues arising under provisions akin to Article 9 (Associated Enterprises) of the OECD Model;
- issues arising under provisions akin to Article 12 (Royalties) of the OECD Model, but only insofar as such a provision might apply in transactions involving related persons to which provisions akin to Article 9 of the OECD Model might apply; and
- any other provisions subsequently agreed by the Contracting Jurisdictions through an exchange of diplomatic notes.

Canada reserved the right to exclude from the scope of the arbitration provisions of the MLI issues pertaining to the application of anti-abuse provisions whether contained in the MLI, a covered tax agreement, or the domestic law of a contracting jurisdiction.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

See **10.1 International Tax Arbitration Options and Procedures** and **10.2 Types of Matters That Can Be Submitted to Arbitration**.

The arbitration provisions of the MLI were largely influenced by the Canada-United States Tax Convention, which incorporated binding final offer arbitration in 2007 to address cases where the competent authorities have endeavoured but are unable to reach a complete agreement under the MAP.

10.4 Implementation of the EU Directive on Arbitration

See **10.1 International Tax Arbitration Options and Procedures**.

10.5 Existing Use of Recent International and EU Legal Instruments

As noted in **10.1 International Tax Arbitration Options and Procedures**, final offer arbitration was incorporated into the Canada-United States Tax Convention in 2007. The relevant rules and procedures are detailed in Annex A to the 21 September 2007 Protocol to the Convention and a Memorandum of Understanding between the competent authorities of Canada and the United States.

10.6 New Procedures for New Developments Under Pillar One and Two

Both Pillar One and Pillar Two are expected to eventually take effect in Canada.

Canada has released legislative proposals to enact a digital services tax effective as of 1 January 2024 in the event that a multilateral treaty implementing the Pillar One tax regime has not come into force. Canada has also affirmed its commitment to introduce legislation implementing the Pillar Two global minimum tax by way of a domestic minimum top-up tax (effective for taxation years beginning on or after 31 December 2023) and an undertaxed profits rule (for taxation years beginning on or after 31 December 2024).

10.7 Publication of Decisions

Canadian law generally prohibits the CRA or other government officials from knowingly disclosing taxpayer information, knowingly allowing such information to be disclosed or knowingly allowing any person to have access to such information. As such, information relating to arbitration proceedings involving Canadian taxpayers will not be made public by the CRA.

10.8 Most Common Legal Instruments to Settle Tax Disputes

See **8.1 Mechanisms to Deal With Double Taxation** and **10.1 International Tax Arbitration Options and Procedures**.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Taxpayers generally rely on outside tax counsel and other professional advisers, including independent economists, in cases involving Canadian competent authority assistance.

11. Costs/Fees

11.1 Costs/Fees Relating to Administrative Litigation

There are no costs or fees associated with the CRA's administrative appeals process.

11.2 Judicial Court Fees

The Tax Court, the FCA and the SCC each charge a fee to the party that initiates a proceeding. This fee is payable at the time the notice of appeal or application for leave to appeal is filed. In the Tax Court, the filing fee is between CAD250 and CAD550, depending on the amount at issue. Filing fees at the FCA and SCC are CAD50 and CAD75, respectively.

The courts' rules specify certain circumstances in which other payments must also be made. For example, non-expert witnesses attending a Tax Court proceeding are entitled to be paid by the party who arranged for their attendance CAD75 per day, plus transportation and living expenses. For certain witnesses, this amount may be increased to up to CAD350 (or a greater amount if the Tax Court's taxing officer sees fit). These and other fees are generally modest relative to the other expenses a party will incur in connection with an appeal.

11.3 Indemnities

Canadian courts will generally order the unsuccessful party in litigation to pay costs to the successful party. In tax disputes, the most substantial costs awards generally arise in relation to litigation in the first instance at the Tax Court.

The Tax Court has broad discretion in the determination of costs awards. The Court may take into account a wide array of factors, including but not limited to the amounts in issue, the importance and complexity of the issues, the

volume of work required, the conduct of the parties and the nature of any settlement offers that were made. The Court may also award costs based on a Tariff annexed to the Tax Court rules.

A cost award will generally not take into account any expenses incurred in contesting an assessment at the administrative appeals stage. It should be noted that cost awards are not intended to fully compensate the successful party for their actual costs incurred and will generally fall significantly short of doing so. However, large costs awards (occasionally in excess of CAD1 million on complex, high-value appeals) are becoming increasingly common.

11.4 Costs of ADR

There is no applicable information in this jurisdiction.

12. Statistics

12.1 Pending Tax Court Cases

As of 31 March 2021 (the most recent date for which official statistics are available), the Tax Court had 8,576 active income tax proceedings and 1,539 active GST/HST proceedings.

As of March 2023, the FCA had 49 active appeals relating to income tax and 17 active appeals relating to GST/HST from decisions of the Tax Court.

With respect to tax cases at the Supreme Court, as of March 2023 there were seven pending applications for leave to appeal, two appeals pending and one appeal heard with judgment under reserve.

12.2 Cases Relating to Different Taxes

The Tax Court does not publish official statistics regarding the number of cases initiated and terminated every year relating to different taxes or their value.

12.3 Parties Succeeding in Litigation

The Tax Court does not publish official statistics regarding the relative success of taxpayers and the CRA in tax litigation. Such statistics would be challenging to assemble due to the frequency that appeals are allowed in part or settled on a confidential basis.

13. Strategies

13.1 Strategic Guidelines in Tax Controversies

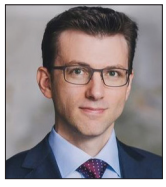
Strategic points are specifically addressed in **2.6 Strategic Points for Consideration During Tax Audits**, **4.5 Strategic Options in Judicial Tax Litigation** and elsewhere throughout the guide.

Trends and Developments

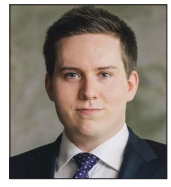
Contributed by:
Christopher Slade and Jacob Brown
Aird & Berlis LLP

Aird & Berlis LLP is one of Canada's premier business law firms with strong recognition both nationally and internationally. Based in Toronto, the lawyers work closely with clients in Canada, the United States, the United Kingdom and around the world on matters involving Canadian law. The firm provides legal and strategic advice in all principal areas of business law, including corporate finance, taxation, banking, insolvency and restructuring, energy, environmental, infrastructure/P3, technology and intellectual property, commercial litigation, workplace law, municipal and land use planning, and real estate. Its tax group is highly regarded for transactional/advisory matters and features one of the largest tax litigation teams in the country.

Authors



Christopher Slade of Aird & Berlis has extensive experience advising on domestic and international tax controversy and litigation matters. He has successfully represented a wide range of clients, including multinational corporations, financial institutions, pension funds and ultra high net worth individuals, and he routinely acts on high-value and complex cases. Chris' strategic approach allows him to position his clients for effective negotiation with the tax authorities, with the objective of obtaining favourable results efficiently and avoiding litigation when possible. He has an exceptional track record, having successfully resolved most of his cases by consent judgment or at the administrative appeals level.



Jacob Brown of Aird & Berlis has experience assisting clients in all aspects of the tax dispute resolution process. Clients appreciate his sound judgement as well as his dedication to resolving disputes efficiently and, wherever possible, without litigation. Jacob's practice also includes advising and representing clients under audit, making disclosures under the Canada Revenue Agency's Voluntary Disclosures Program, challenging administrative action by the tax authorities and making requests for interest and penalty relief as well as other discretionary remedies.

Aird & Berlis LLP

Brookfield Place
181 Bay Street
Suite 1800
Toronto
Canada
M5J 2T9

Tel: +416 863 1500
Fax: N/A
Email: airdberlis@airdberlis.com
Web: www.airdberlis.com

Introduction

This article discusses two significant developments in Canadian tax law:

- the proposal by Canada's federal Department of Finance to modify Canada's domestic General Anti-Avoidance Rule (GAAR); and
- the decision of the Supreme Court of Canada to hear two appeals concerning the jurisdictions of the Tax Court of Canada and the Federal Court of Canada over tax matters.

The proposed amendments to the GAAR could introduce a new era of uncertainty regarding the scope of the GAAR and redefine what is considered "acceptable tax planning" in Canada, whereas the Supreme Court of Canada's eventual ruling may have far-reaching implications regarding the Tax Court of Canada's jurisdiction over disputes involving the powers of the Canada Revenue Agency to audit and assess tax.

Proposed Amendments to the GAAR

The GAAR has been a feature of Canada's federal Income Tax Act (ITA) since 1988. Where the GAAR applies, the tax consequences of the relevant transaction or series of transactions are determined as is reasonable in the circumstances in order to deny any tax benefit that, but for the GAAR, would result.

Canada's federal taxation authority (the Canada Revenue Agency or CRA) has applied the GAAR more than 1,300 times. In approximately 30 cases, the taxpayers unsuccessfully challenged the CRA's position in court. These cases involved a wide spectrum of creative tax planning, including:

- a tax loss monetisation (loss trading) arrangement that circumvented a de jure control test designed to prevent the use of losses following an acquisition of control (Deans Knight Income Corporation v Canada, 2023 SCC 16, judgment on appeal to the Supreme Court currently under reserve);
- transactions designed to defeat the rationale of the capital dividend account regime, which allows for the tax-free distribution of the non-taxable portion of capital gains realised by a corporation (Gladwin Realty Corporation v The Queen, 2020 FCA 142);
- artificially increasing paid-up capital (which can be returned to shareholders tax-free) through a series of transactions that transformed a "vertical" amalgamation into a "hori-

zontal" amalgamation (Copthorne Holdings Ltd v Canada, 2011 SCC 63); and
- rolling real estate properties through a tiered partnership structure so as to increase adjusted cost base, then selling interests to tax-exempt entities to avoid tax on latent recapture and accrued gains (Canada v Oxford Properties Group Inc., 2018 FCA 30).

On the other hand, in approximately two dozen other cases, the courts agreed with the taxpayers that the GAAR did not apply. These cases include two of the six GAAR appeals decided by the Supreme Court.

In response to the growing body of jurisprudence and prior commitments made to strengthen the GAAR, Canada's federal Department of Finance (Finance) released a consultation paper in August 2022 entitled "Modernising and Strengthening the General Anti-Avoidance Rule", which identified a number of specific issues with the GAAR and outlined potential changes. Following through on that process, Finance proposed significant amendments to the GAAR in the 2023 Canadian federal budget (Budget 2023), which was released in March 2023. These proposed amendments are described below. If enacted, they could have a material impact on tax planning in Canada and would likely lead to an increase in GAAR disputes.

The GAAR at Present

The GAAR generally denies a "tax benefit" that results from an "avoidance transaction" if it may reasonably be considered that the transaction, or a series of transactions of which the transaction is part:

- directly or indirectly results in a misuse of the provisions of the ITA, the Income Tax Regulations, the Income Tax Application Rules, a tax treaty, or any other enactment that is relevant in computing tax consequences under the ITA; or
- would result directly or indirectly in an abuse having regard to those provisions, read as a whole.

"Tax benefit" is defined as a reduction, avoidance or deferral of tax or other amount payable under the ITA, or an increase in a refund of tax or other amount under the ITA (including in cases involving a tax treaty).

An "avoidance transaction" is one from which a tax benefit directly or indirectly results, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. An avoidance transaction also includes a transaction undertaken as part of a series of transactions that results in a tax benefit (subject to the same bona fide purpose exception).

In Canada Trustco Mortgage Co v R, 2005 SCC 54, the Supreme Court explained that tax avoidance may be abusive where:

- the taxpayer relies on specific provisions to achieve an outcome that those provisions seek to prevent;
- a transaction defeats the underlying rationale of the provisions that are relied upon; or
- an arrangement circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats their object, spirit or purpose.

Budget 2023

In Budget 2023, Finance proposed a number of substantive changes to the GAAR, including:

- lowering the threshold of "avoidance transaction" from a "primary purpose" test to a "one of the main purposes" test;
- expressly introducing the concept of economic substance;
- introducing a new 25% penalty; and
- extending the applicable limitation period for GAAR assessments by an additional three years unless certain reporting requirements are met.

Lowering the "avoidance transaction" threshold

The GAAR applies only if there is an avoidance transaction, which is currently defined to mean a transaction that is undertaken primarily to obtain a tax benefit. Finance has proposed to reduce this threshold from a "primary purpose" test to a "one of the main purposes" test, which could materially broaden the GAAR's scope. In Finance's view, this proposed change strikes a reasonable balance, with the proposed test applying to transactions with a significant tax avoidance purpose, but not to transactions where tax was simply a consideration. We note that, even under the proposed new threshold, avoidance of foreign (ie, non-Canadian) tax should still qualify as a bona fide non-tax purpose.

Introducing the concept of economic substance

The existing GAAR jurisprudence takes into account considerations relating to lack of economic substance. Notwithstanding this, Finance has proposed to amend the GAAR to explicitly state that, if an avoidance transaction is significantly lacking in economic substance, it tends to indicate that the transaction results in a misuse or abuse. In this regard, Finance's proposed draft legislation provides that the following factors tend – depending on the particular circumstances – to establish that a transaction or series of transactions is significantly lacking in economic substance:

- all, or substantially all, of the opportunity for gain or profit and risk of loss of the taxpayer – taken together with those of all non-arm's length taxpayers – remains unchanged, including because of a circular flow of funds, offsetting financial positions, or the timing between steps in the series of transactions;
- it is reasonable to conclude that, at the time the transaction was entered into, the expected value of the tax benefit exceeded the expected non-tax economic return (which excludes both the tax benefit and any tax advantages connected to another jurisdiction); and
- it is reasonable to conclude that the entire, or almost entire, purpose for undertaking or arranging the transaction or series was to obtain the tax benefit.

New 25% penalty

Budget 2023 has also proposed to introduce a new penalty of 25% of the amount of the tax benefit where the GAAR is found to apply. However, the penalty could be avoided if the transaction is disclosed to the CRA, either voluntarily or as part of proposed mandatory disclosure rules.

Three-year extension to the normal reassessment period

Finally, a three-year extension to the normal reassessment period would be provided for GAAR assessments, unless the transaction had been disclosed to the CRA. This would effectively extend the limitation period to six, seven or ten years, depending on the type of taxpayer and the transactions involved.

Potential Impact of the Proposed Amendments

Taken together, the proposed amendments represent the most significant legislative development in this area of Canadian tax law in the past 35 years. During that period, the courts have incrementally refined the GAAR over the course of more than 50 decided cases. If enacted, the proposed amendments would likely result in a period of increased uncertainty and litigation as the new rules are tested in the Canadian courts.

The proposed "economic substance" amendments could materially expand the concept of "misuse or abuse" and bring within the scope of the GAAR many transactions currently regarded as acceptable. The amendments could also encourage the CRA to reassess freely in an effort to chart the limits of the new rules. Despite this, Finance states that a lack of economic substance will not always mean that a transaction is abusive and it would still be necessary to determine the object, spirit, and purpose of the provisions or scheme relied upon, in line with existing GAAR jurisprudence.

Additionally, the introduction of a penalty and extended limitation periods could effectively compel taxpayers to self-report transactions that might be characterised as avoidance transactions. This could, in turn, discourage creative tax planning as well as certain types of legitimate business transactions. Another possible unintended result is that the CRA could be inundated with reports from taxpayers wishing to avoid potential exposure to the proposed 25% penalty and extended limitation periods.

The Supreme Court Agrees to Hear Appeals Regarding Canada's Divided Jurisdiction Over Tax Disputes

In Canada, there are generally two parallel but mutually exclusive tracks for resolving different types of disputes arising under the ITA and Part IX of Canada's federal Excise Tax Act (ETA), which governs Canada's value-added tax known as the Goods and Services Tax/Harmonized Sales Tax (GST/HST). The first track (referred to in this article as the Substantive Track) generally deals with the correctness of tax assessments and normally begins with the taxpayer filing a notice of objection to a disputed assessment. If the CRA confirms the assessment or does not render a decision within 90 days, the taxpayer may appeal to the Tax Court of Canada (the Tax Court), a court established primarily to decide cases regarding the correctness of tax assessments. On such an appeal, the Tax Court has the power to vacate or vary the disputed assessment, or send it back to the CRA for reconsideration and reassessment.

The second track (referred to in this article as the Administrative Track) concerns challenges to decisions made and actions taken by the CRA on behalf of Canada's Minister of National Revenue (the Minister), in administering the ITA/ETA. Common examples of this type of administrative action include CRA refusals to grant discretionary relief from interest and penalties and actions taken by the CRA in conducting audits or collecting amounts owing. Where a taxpayer disagrees with such a decision or administrative action, the taxpayer may apply for judicial review in the Federal Court of Canada (the Federal Court), which has had jurisdiction over administrative actions and decisions of federal agencies since its establishment in 1971. On such an application, the Federal Court has the power to:

- order the CRA to do anything that the CRA has unlawfully failed or refused to do, or has unreasonably delayed in doing;
- prohibit the CRA from doing something; or
- set aside a decision of the CRA, with or without referring the matter back to the CRA for redetermination.

Decisions of both the Tax Court and the Federal Court can be appealed to the Federal Court of Appeal (the FCA).

Explained in this manner, the distinction between the Substantive Track and the Administrative Track may appear relatively clear. However, over the years, numerous taxpayers have been denied relief to which they might otherwise have been entitled because they chose the wrong track. The judges of the different courts involved have also repeatedly disagreed about where cases belong. It is perhaps because of this that the Supreme Court recently granted leave to appeal from the FCA's decisions in Canada v Dow Chemical Canada ULC, 2022 FCA 70 [Dow Chemical] and Canada (Attorney General) v Iris Technologies Inc., 2022 FCA 101 [Iris].

The JP Morgan Decision

In order to better understand the issue, it is helpful to review the FCA's leading decision in Canada (National Revenue) v JP Morgan Asset Management (Canada) Inc., 2013 FCA 250 [JP Morgan]. In that case, the CRA had assessed the taxpayer (JP Morgan) for withholding tax on certain fees paid many years earlier to a related Hong Kong company. Instead of appealing the assessments to the Tax Court, JP Morgan applied to the Federal Court for judicial review and requested that the assessments be set aside on the basis that the decision to issue them was inconsistent with the CRA's administrative policy to limit such assessments to more recent periods. Rather than allowing the application to proceed, the CRA asked the Federal Court to strike JP Morgan's application because it dealt with the validity of income tax assessments, which is a matter outside the Federal Court's jurisdiction.

In its decision, the FCA explained that an application for judicial review should be struck out if it has, among other things, any of the following flaws:

- the application fails to state a ground of review recognised in "administrative law";
- the claim made in the application cannot be dealt with by the Federal Court for another reason; or
- the relief sought in the application cannot be granted by the Federal Court.

The FCA ultimately held that JP Morgan's application had all three flaws and should therefore be struck out.

Grounds of review recognised in administrative law

Administrative law deals with, among other things, the grounds on which a court may review a decision made by an administrative agency like the CRA. Grounds of review recognised in Canadian administrative law include:

- a decision or action being outside the administrative agency's legal authority;
- a decision being made in a procedurally unfair way; or
- a decision being substantively unacceptable (ie, incorrect or unreasonable, depending on the particular decision).

The third ground includes claims that an administrative agency has "abused its discretion". Examples of abusing discretion include:

- making a decision for an improper purpose or in bad faith;
- acting under the dictation of someone not authorized to make the decision; and
- "fettering of discretion" (eg, where the decision maker follows an administrative policy without considering the specific facts of the case before it).

Other reasons that the Federal Court might not be able to deal with a claim

Even if there is a valid administrative law ground of review, judicial review may still be unavailable for another reason. For example, the Federal Court is forbidden from dealing with matters that can be appealed to the Tax Court. These matters include:

- the validity of assessments (ie, whether an assessment is supported by the facts of the case and the applicable law);
- the admissibility of evidence supporting an assessment (eg, whether evidence is inadmissible because the CRA violated the taxpayer's constitutional rights); and
- abuses of the Tax Court's own processes (ie, misconduct by the government within the Tax Court appeal process).

Because judicial review is intended to be a remedy of last resort, the Federal Court is also precluded from reviewing an administrative decision if the taxpayer has adequate, effective recourse elsewhere or at another time. This could include bringing a civil lawsuit against the CRA or seeking discretionary relief that may be available either administratively or under statute.

Relief that the Federal Court cannot grant

As discussed above, the Federal Court has broad powers to grant relief from flawed administrative decisions. However, these powers have important limits. Notably, the Federal Court does not have the power to vary, set aside or vacate tax assessments, or the power to compel the CRA to act (or refrain from acting) in a way that is contrary to statute.

Dow Chemical and Iris

The decisions in Dow Chemical and Iris demonstrate that, despite the FCA's efforts to coherently summarise the law in JP Morgan, the relationship between the Substantive Track and the Administrative Track has continued to generate uncertainty and controversy.

The dispute in Dow Chemical arose in the context of a transfer-pricing audit and concerns the circumstances under which a taxpayer can obtain a downward transfer-pricing adjustment. In that case, the CRA auditor had concluded that the income of the taxpayer (Dow Chemical) should be adjusted upward under Canada's transfer-pricing rules, and Dow Chemical requested that certain downward adjustments also be made.

Under subsection 247(10) of the ITA, a downward transfer-pricing adjustment may only be made where, in the opinion of the Minister, the circumstances are such that it would be appropriate. The CRA (acting on behalf of the Minister) was of the opinion that it would not be appropriate in Dow Chemical's case, and issued a reassessment that included only upward adjustments.

Dow Chemical opted to seek relief on both the Substantive Track and the Administrative Track, appealing the reassessment to the Tax Court and also applying for judicial review of the CRA's decision to deny the requested downward adjustment. The application for judicial review is currently being held in abeyance pending the outcome of the process that began in the Tax Court.

In the Tax Court, Dow Chemical asked for a determination of whether that court has jurisdiction to review a CRA decision to deny a downward adjustment. The Tax Court concluded that it did, on the basis that it has the jurisdiction to review the correctness of an assessment and, if the CRA's decision regarding a downward adjustment is not made in accordance with proper legal principles, then the assessment is incorrect.

On appeal, the FCA reversed the Tax Court's decision on the basis that an assessment denying a downward adjustment is only incorrect if the Minister is of the opinion that a downward adjustment was appropriate. Since in Dow Chemical's case the CRA was of the opinion that a downward adjustment was not appropriate, and given that the Tax Court has no power to order the Minister to change her opinion, the Tax Court had no jurisdiction to grant the relief sought.

In Iris, the taxpayer (Iris) had been audited and assessed by the CRA for unremitted GST/HST. Iris applied to the Federal Court for judicial review and asked that the court make the following declarations:

- Iris was denied procedural fairness in the audit and assessment process;
- there was no evidentiary foundation upon which the GST/HST assessments could be issued; and
- the assessments were issued for the improper purpose of depriving the Federal Court of jurisdiction to hear administrative law grievances raised by Iris in a related application.

The CRA asked that the Federal Court strike Iris' application and argued that, among other things, Iris was trying to circumvent the exclusive jurisdiction of the Tax Court. The Federal Court refused, concluding that, among other things, the application was not an attack on the assessments but on the procedural fairness of the assessments.

On appeal, the FCA overturned the Federal Court's decision and struck out Iris' application. In reaching its decision, the FCA concluded that Iris' application was, in essence, a collateral attack on the validity of the assessments – an issue which is off limits for the Federal Court, according to the principles confirmed in JP Morgan. The FCA also noted that only the Tax Court has the power to vacate a disputed assessment, and that the declarations sought from the Federal Court would serve little or no purpose.

In March 2023 the Supreme Court granted leave to appeal the decisions of the FCA in Iris and Dow Chemical, and directed that the appeals be heard together. The appeals are likely to be heard before the end of 2023, with a decision to follow approximately six months later.

Future Developments

Over the years, tax practitioners have frequently criticised the fact that there is no one-stop shop for taxpayers seeking to resolve their disputes with the CRA, and some have characterised the existing division of jurisdiction between the Tax Court and the Federal Court as arbitrary. To date, Canada's Parliament has been unreceptive to calls for legislative change in this regard, and no movement is expected on that front in the near future.

In Dow Chemical and Iris, the Supreme Court will likely attempt to clarify the respective jurisdictions of the Tax Court and Federal Court, which will hopefully reduce the number of taxpayers ending up on the "wrong" track as well as the

number of Tax Court and Federal Court decisions on this issue. What remains to be seen is whether this will be done by attempting to draw brighter jurisdictional lines, or whether the Supreme Court will instead direct the lower courts to take a more flexible approach in determining questions of jurisdiction. Either approach could have material implications for disputes involving the CRA's powers to audit and assess tax.

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