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Aggressive Tax Planning and Inherent Risks: Would Canada Benefit by Adopting Tools Developed by Some of Its Trading Partners?

The Canadian Context

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Abstract

The Canadian Context

It did not take long for taxpayers to take advantage of the principle whereby they may plan their affairs in order to minimize their tax payable. Some taxpayers have thus implemented aggressive tax planning schemes for various reasons, ranging from the variable importance that they attach to their civic duty to the quest for the lowest tax rate, and including their perception of the consequences stipulated by the law when there is a risk that a planning scheme contravenes anti-avoidance rules.

While taxpayers are responsible for the accuracy of their income tax returns under a self-assessment tax system, they may seek the expertise of tax advisers in various disciplines to help them fulfil their obligations or, for the more aggressive taxpayers, in exercising the privilege of organizing their affairs to pay as little tax as possible.

Tax advisers sometimes find themselves in a conflicting position in which they must strike a balance between their duty of loyalty to their clients and compliance with the ethical standards to which they may be subject when applying the tax rules. This situation arises, among other things, because of the clients' demands and competition among tax advisers to elaborate new aggressive tax planning schemes.

The terminology used in the literature usually tends to distinguish between acceptable planning schemes, i.e. those carried out within the limits of the law, and illegal, even fraudulent schemes. The difficulty consists, by and large, in finding a way to describe planning schemes that lie between these two extremes, i.e. that fall under the heading of tax avoidance. A planning scheme that lies in the grey area surrounding the limits of legitimate tax planning schemes might then be deemed to be an aggressive tax planning scheme.

Observations made over the years by Canada's auditors general mention the risks that aggressive tax planning schemes pose to the integrity of the taxation system and the erosion of government revenues. To mitigate such risks, the tax administration has taken initiatives to prevent the proliferation of aggressive tax planning schemes. It must nonetheless be acknowledged that such tax planning schemes continue to pose a challenge to all stakeholders in Canada.

The uncertainty surrounding the parameters that define acceptable planning schemes in relation to those that are not is the crux of this challenge. A clearer distinction between legitimate planning schemes and tax avoidance schemes would be advisable. Beyond the terminology, it is important to establish this distinction based on objective criteria that reflect the purposes of the law. However, for the tax administration, the definition of new parameters concerning the distinction between legitimate planning schemes and tax avoidance would not, of itself, succeed

in influencing taxpayers' and advisers' decisions concerning the risks and consequences of aggressive tax planning schemes.

To meet the challenge that aggressive tax planning schemes pose, the tax administration must adopt an array of tools applicable to each of the parties involved in the implementation of aggressive tax planning schemes. Under a self-assessment tax system, the tax administration can probably only heighten the risks and develop tools to detect in real time the aggressive tax planning schemes implemented. Among the range of tools that the tax administration can adopt, access to information in tax matters is, in all likelihood, central to finding possible solutions.

Regardless of the possible solutions contemplated, it will be important they reconcile the principle of tax equity between different taxpayers, on the one hand, and the needs and constraints of taxpayers and the tax administration, on the other hand.

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Introduction

For a number of years, numerous public and private agencies around the world have worried about the increasing difficulty in distinguishing between tax evasion and tax avoidance, both of which erode government revenues and undermine the integrity of the taxation system. The literature occasionally uses these concepts interchangeably, but the notion of tax evasion, contrary to that of tax avoidance, implies fraud. The dividing line between these concepts is hard to delineate and a planning scheme could approach the line without overstepping it. Such a planning scheme could be described as an aggressive tax planning scheme.

This study is intended to analyse the tools implemented to overcome the problems that such planning schemes pose. For practical reasons, the study has been divided into two parts, the first of which examines the Canadian fiscal environment from the standpoint of aggressive tax planning schemes. The second part will examine the situation in the United States, the United Kingdom and Australia, as well as the European Union, some of Canada's trading partners. To this end, we will analyse the key tools adopted in these jurisdictions to contain such planning schemes. We will examine the appropriateness of adapting one or the other of these tools to the Canadian taxation system.

This part of the study is divided into four sections. The first section examines tax avoidance in Canada. It begins with a cursory historic overview and terminological review, and then briefly presents the stakeholders concerned with aggressive tax planning schemes. It concludes with certain statistical and other indicators that reveal that the government is concerned with avoidance from the standpoint of the integrity of the taxation system.

The second section focuses on the stakeholders, i.e. taxpayers, tax professionals and the tax administration, and the risks that aggressive tax planning schemes pose for them.

In the third section, we identify the tools that the Canadian tax administration has adopted to contain aggressive tax planning schemes. In the final section, we formulate possible solutions to limit reliance on such schemes.

The literature on tax avoidance is indeed extensive. Consequently, this study is not intended to answer all questions in this respect. Instead, it seeks to initiate a dialogue here in Canada on this phenomenon and the entire question of the risk that it engenders both for the tax administration and for taxpayers and tax professionals.

1

Tax avoidance in Canada

Based on the premise that taxes are compulsory remittances and not voluntary contributions, the brief historic overview that follows reveals that it did not take long for Canadian taxpayers to plan their affairs in order to reduce their Canadian tax payable and that it was not long before the Canadian tax administration reacted to the "fiscal creativity" of taxpayers and their tax advisers.

1.1 A brief historic overview of the situation in Canada

A federal income tax in Canada was introduced in 1917 when revenues from indirect taxes were insufficient to fund the country's war effort. The government announced that the tax was temporary but it was maintained to finance government debt following the war and its socioeconomic aftermath.

The *Income War Tax Act*[1] at that time contained only a limited number of measures aimed at preventing taxpayers from engaging in certain tax planning schemes. Taxpayers then began to plan their affairs in order to avoid paying this tax. Consequently, disputes between the tax administration and certain taxpayers were referred to the Canadian courts. Following the example of other countries, the Canadian courts recognized the principle whereby taxpayers may plan their affairs in order to reduce their tax, a principle adopted in 1936 by an English court:

> Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[2]

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1 *Income War Tax Act,* S.C. 1917, c. 28.
2 *IRC* v. *Duke of Westminster* (1936) 19 TC 490, page 520.

One of the first anti-avoidance rules was introduced in Canada in 1938. The Treasury Board was then granted discretionary power to take appropriate measures to rescind tax benefits stemming from tax avoidance or tax reduction arrangements although such planning schemes were not illegal. In 1945, the *Income War Tax Act* made provision for over one hundred specific discretionary measures.[3] Moreover, in 1948, the Canadian Parliament adopted two anti-avoidance rules, one aimed at rescinding deductions for expenses claimed by taxpayers that artificially or unduly reduced their income and the second one aimed at including in the calculation of income the value of benefits conferred on a taxpayer by another person in conjunction with transactions, regardless of the form of the advantages or the existence of an intention by the taxpayer to avoid tax.[4]

In 1966, the Royal Commission on Taxation, chaired by Kenneth Carter and known as the Carter Commission, examined the difficulty of defining the expression "tax avoidance." For the purposes of the report, the Commission defined it as any attempt undertaken within the legal framework with a view to preventing or reducing by taking advantage of some provision or shortcoming in the law subjection to the tax to which the concerned party would otherwise be subject.[5] The Commission had pinpointed certain schemes that taxpayers used to reduce their tax.[6] Moreover, it recommended that the taxation system include measures to counter avoidance manoeuvres. It suggested that such measures be drafted in fairly general terms, without being overly vague, to enable the courts to interpret them in light of the purpose and the spirit of the Canadian *Income Tax Act* at the time.

Following the tabling of the report of the Royal Commission on Taxation, the Canadian government, in a white paper submitted by the then Finance Minister Edgar Benson, introduced a

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3 Howard J. Kellough, "Tax Avoidance: 1945-1995," (1995), Vol. 43, No. 5, *Canadian Tax Journal* 1819.

4 *Ibid.*, note 3.

5 Canada, Royal Commission on Taxation, *Taxation of Income: Part A – Taxation of Individuals and Families,* Volume 3, 1966, pages 617-662.

6 The schemes identified by the Royal Commission included, among other things, income splitting by means of trusts, surplus stripping, the acquisition of losses, the reception of funds as capital rather than income, and the transfer of revenue to a corporation or a trust residing in a country where the income tax rates are low or indeed null.

tax reform centred on certain objectives, including the establishment of a simpler taxation system to ensure that taxpayers complied with it which would nonetheless contain sufficiently detailed measures to eliminate loopholes and attempts by taxpayers to abuse the system.[7]

The *Income Tax Act* of 1972[8] contained more extensive specific anti-avoidance measures but still did not generally define tax avoidance. Specific anti-avoidance rules proliferated in the Act in the 1980s, thus adding to the legislation's complexity. The *1986 Report of the Auditor General of Canada* reported on tax planning schemes centred on losses and unused tax credits and reliance on limited partnerships. The report indicated that tax avoidance by taxpayers already led at the time to losses of hundreds of millions of dollars for the Canadian tax administration.[9]

Given the extent of commercial and financial transactions and the frequency with which new avoidance schemes were being created, in 1988 the Canadian Parliament adopted a general anti-avoidance rule (GAAR), which defined the concept of "tax avoidance" and "abusive tax avoidance" for Canadian taxpayers. Subsection 3.1 of this study examines the GAAR in greater detail.

Several annual reports of the Auditor General of Canada refer to tax avoidance schemes, in particular those linked to reliance on tax havens, transactions between Canadian corporations with their foreign affiliates, financing structures which include, among others, techniques that maximize the value of the deductibility of interest and weak currency borrowings schemes, planning schemes involving foreign trusts, reliance on tax treaties, and reliance on tax shelters.[10]

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7 The Honourable E.J. Benson, *Proposals for Tax Reform,* 1969, pages 6 and 8.

8 *Income Tax Act,* S.C. 1970-71-72, c. 63.

9 Canada, *1986 Report of the Auditor General of Canada*, Chapter 1, "Matters of Special Importance and Interest," par. 1.68., and Chapter 4, "Income Tax Expenditures," par. 4.31 to 4.54, 1986.

10 See Appendix 1, "Overview of certain annual reports of the Auditor General of Canada relevant to this study" for the key reports that mention tax avoidance problems.

Part of the *1996 Report of the Auditor General of Canada* focused exclusively on the fight against income tax avoidance.[11] Among other things, the Auditor General noted the following:

> Taxpayers are entitled to arrange their affairs to minimize their tax costs. Avoidance occurs when such arrangements subvert the purpose of taxation provisions. Taxpayer-developed avoidance schemes were not contemplated by the legislators. They are contrary to the object and spirit of the law and frustrate its purpose. Unlike tax expenditure programs, which give relief to taxpayers who have fulfilled conditions that further the government's specific economic or social objectives, these schemes do not relate to any specific objectives and are seldom seen as furthering the general intent of the legislation.[12]

As for Revenue Canada (now the Canada Revenue Agency (CRA)) tax avoidance program, it added that this program was essential to promote public trust and confidence in the fairness and integrity of the income tax system. Tax avoidance schemes have a negative impact on the equity and integrity of the tax system and on attitudes toward voluntary compliance.[13] In his conclusions, the Auditor General noted:

> The cost of tax avoidance is not known. However, the results of Revenue Canada's program to combat it indicate that avoidance continues to pose a serious threat to the tax base. The Department expects the program to produce about $365 million in reassessments in 1995-96.[14]

Moreover, since the implementation of the GAAR, certain tax planning schemes have been submitted to an anti-avoidance committee[15] established by the CRA. As of October 31, 1995, the committee had received 148 files. The establishment of a reassessment, based at least partially on the rule, was approved in 29 of these cases, and a reassessment was contemplated in 66 other cases. The committee decided that the rule did not apply to the 53 remaining cases.[16] Ten years later, as of June 30, 2005, the committee had examined 628 files since its inception. It decided

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11 Canada, *Report of the Auditor General of Canada*, May 1996, Chapter 11, "Revenue Canada—Combatting Income Tax Avoidance".

12 *Ibid.*, par. 11.5.

13 *Ibid.*, par. 11.9.

14 *Ibid.*, par. 11.84.

15 Among other things, this committee has a mission to detect and examine the aggressive tax planning schemes pinpointed in conjunction with audits. It also administers the GAAR in the CRA to ensure that it is applied uniformly.

16 *Supra*, note 11, par. 11.37.

that the GAAR could apply to 417 of them and that it was not applicable to 211 files. The transactions examined as of June 30, 2005 focused, among other things, on certain international financing structures used to create or import interest expenses, tax treaties, including “treaty shopping,” the avoidance of paragraph 85.1(4) of the Act at the time of disposal of shares in foreign affiliates and surplus stripping.[17]

Over the past 10 years, the Canadian Parliament has continued to frequently amend the Act in order to remedy changes in aggressive tax planning schemes, in particular by adopting new specific anti-avoidance measures.[18] As for the GAAR, the 2004 federal Budget specified that it also applies retroactively to the regulations of the Act and to tax agreements.[19] The total number of assessments appealed before Canadian courts, which stood at four in 1996, has only reached 20 to date and it was only on October 19, 2005 that the Supreme Court of Canada handed down its first two rulings on the GAAR in the *Canada Trustco* and *Mathew* cases.[20] While these Supreme Court of Canada rulings offer useful indications on the appropriate scope and application of the GAAR, it will take some time before all of the consequences of these rulings are clarified.

1.2 Terminology

One of the difficulties that arise with respect to tax avoidance is to define and distinguish certain of the terms used in the literature. For the purposes of this study, we will confine ourselves to the following expressions: a) legitimate tax planning; b) tax evasion; c) tax avoidance; and d) aggressive tax planning.

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17 “2005 CRA Round Table,” 57th Annual Conference, Vancouver, Canadian Tax Foundation, September 2005.

18 For an overview of the key measures adopted by the Minister of Finance Canada in recent years, see Canada, Minister of Finance, *Budget Plan 2004*, Appendix 1, “Update on Federal Tax Reductions” under the section “Tax Measures to Support Economic and Social Objectives, Enhance Tax Fairness and Improve the Tax Structure,” pages 228 *et seq*. See also *Budget Plan 2005,* pages 457-458, for proposals concerning the deductibility of interest, non-resident trusts, and foreign investment entities.

19 *Budget Implementation Act, 2004, No. 2*, S.C. 2005, c. 19, s. 52, assented to May 13, 2005.

20 *Canada TrustcoMortgage Co.* v. *Canada*, 2005 S.C.C. 54 [*Canada Trustco*] and *Mathew* v. *Canada*, 2005 S.C.C. 55 [*Mathew*].

As the Supreme Court of Canada recently noted in the *Canada Trustco* case, the dividing line between the legitimate reduction of tax and abusive tax avoidance is far from clear.[21] Moreover, what is acceptable or unacceptable from a fiscal standpoint may vary from one country to the next. While definitions of or distinctions concerning these concepts abound in the literature, we deemed it appropriate for the purposes of this study to use those elaborated by the Organisation for Economic Co-operation and Development (OECD) and, more specifically for Canada, by the tax administration.

1.2.1 Legitimate tax planning

The OECD defines tax planning as an "arrangement of a person's business and/or private affairs in order to minimize tax liability."[22]

Since the fall of 2005, the CRA has indicated on its Website that "Tax avoidance and tax planning both involve tax reduction arrangements that may meet the specific wording of the relevant legislation. Effective tax planning occurs when the results of these arrangements are consistent with the intent of the law. When tax planning reduces taxes in a way that is inconsistent with the overall spirit of the law, the arrangements are referred to as tax avoidance."[23]

1.2.2 Tax evasion

According to the OECD, tax evasion is "a term that is difficult to define but which is generally used to mean illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities."[24]

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21 *Canada Trustco*, *supra* note 20 par. 16.
22 http://www.oecd.org/document/29/0,2340,en_2649_201185_33933853_1_1_1_1,00.html.
23 http://www.cra-arc.gc.ca/gncy/lrt/vvw-eng.html.
24 *Supra*, note 22.

The CRA specifies that "[t]ax evasion typically involves deliberately ignoring a specific part of the law. For example, those participating in tax evasion may under-report taxable receipts or claim expenses that are non-deductible or overstated. They might also attempt to evade taxes by wilfully refusing to comply with legislated reporting requirements."[25]

Generally speaking, in 1994, Vito Tanzi, former director of the Public Finance Department of the International Monetary Fund (IMF), described as follows tax evasion and his description is still highly relevant a decade later:

> Tax evasion is a universal phenomenon. It takes place in all societies, in all social classes, in all professions, in all industries, in all religions and in virtually all economic systems. … Tax evasion varies by sector, organization of production or type of economic agent (salaried, self-employed, capital owner). It is also affected by social ethics and the standards set by those that govern. Given those standards, it is further affected by the attitude toward risk of a potential taxpayer". … Tax evasion affects the horizontal and vertical equity of a tax system, as well as the efficiency of the free market in general and of its tax system in particular. It affects the revenue productivity of the tax system. Unchecked or deficiently controlled tax evasion builds cynicism about the role of the public sector. It tends to complicate the tax structure as legislators begin to anticipate tax evasion through the tax legislation.[26]

1.2.3 Tax avoidance

In its glossary of tax terms, the OECD defines tax avoidance as "a term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow."[27]

In the wake of the launching on November 14, 2005 of its "Tax Alert" initiative, the CRA now proposes on its Website an explanation of the concept of tax avoidance:

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25 *Supra*, note 23.

26 Vito Tanzi and Parthasathi Shome, "A Primer on Tax Evasion,", (1994), Vol. 48, No. 6/7, *Bulletin for International Fiscal Documentation*, pages 328-337.

27 *Supra*, note 22.

> Tax avoidance occurs when a person undertakes transactions that contravene specific anti-avoidance provisions. Tax avoidance also includes situations where a person reduces or eliminates tax through a transaction or a series of transactions that comply with the letter of the law but violate the spirit and intent of the law. It was to address these latter situations that the general anti-avoidance rule was enacted in 1988.[28]

1.2.4 Aggressive tax planning

The literature uses an array of qualifiers to refer to the diversity of planning schemes that fall within the grey area of tax avoidance, e.g. sophisticated, abusive, creative, aggressive and unacceptable. For the purposes of this study, we have adopted the expression "aggressive tax planning" because the authors of this study believe that it properly renders the notion of risk management for different stakeholders.

In its *Summary of the Corporate Business Plan 2005-2006 to 2007-2008*, the CRA indicates that it will, among other things, place greater emphasis on aggressive tax planning. To this end, it describes such planning:

> In Canada, it involves transactions, arrangements or events that are normally fully disclosed but undertaken to achieve a tax result that is not supportable within specific anti-avoidance provisions or the overall scheme of the Income Tax Act, Excise Tax Act, or Income Tax Conventions. Typically, the transactions, arrangements or events lack economic substance and commercial reality and would not have materialized except for the tax result sought. The transactions, arrangements or events result in: sheltering income and capital gains that should be reported; creating or inflating tax deductions and losses, including capital losses,that would not otherwise exist; misusing treaty provisions; or accessing tax incentives, credits and exemptions in an offensive manner.
>
> Aggressive tax planning undermines the integrity of tax laws and the tax base.[29]

However, it is worth noting that in the French version of the document, the CRA uses the expression "planification fiscale audacieuse." The French expression "planification fiscale

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[28] *Supra*, note 23.

[29] Canada, Canada Revenue Agency, *Summary of the Corporate Business Plan 2005-2006 to 2007-2008* [CRA, *Business Plan 2005-2008*], page 17.

audacieuse" does not fully translate the English expression. The English version undoubtedly more clearly illustrates that this is, in fact, a form of tax avoidance.

1.3 Introduction of the stakeholders and inherent risks for each of them

The CRA, like tax administrations around the world, has a mandate to ensure that taxpayers pay their fair share of tax. Most tax administrations have recognized the principle that taxpayers have the right to organize their affairs in such a way as to reduce their tax debt. They have had to face and more than ever are having to face the challenge posed by the numerous aggressive tax planning schemes put forward by taxpayers themselves or by their tax advisers.

The stakeholders concerned by tax avoidance are thus taxpayers, tax advisers, tax administrations and the courts. The following section presents a general survey of the risks inherent in planning schemes for each stakeholder, which are obviously not of the same nature for all of them. Section 2 of the study proposes a more thorough analysis of such risks and the issues at stake for each stakeholder.

1.3.1 Taxpayers

The willingness of taxpayers to comply with the basic principles of the Canadian taxation system (self-assessment and voluntary compliance) may depend, among other things, on their perception of the efficacy of the Canadian tax administration's compliance and execution programs and the harshness of penalties for non-compliance.

If the taxpayer believes that there is little likelihood of his being audited by the tax administration, he may, generally speaking, be more inclined to rely on certain tax avoidance schemes in order to minimize his total tax payable. The taxpayer thus compares to some extent the risks, e.g. financial risks or the reputation risk and the tax costs (interest and penalties) linked to the likelihood of receiving from the tax administration an assessment with the possible economic gains that could be obtained through aggressive tax planning schemes.

1.3.2 Tax professionals

Many taxpayers rely on the services of tax professionals because of the complexity of tax legislation or to take advantage of their expertise in the realms of tax compliance and planning.

Tax professionals are usually able to assess the risk that the tax administration will audit the income tax returns that they prepare for their clients or the planning schemes that they propose to them and, possibly, issue an assessment. Certain tax professionals are obviously more aggressive than others in their professional practice.

Most of them belong to a professional board and are subject, in Canada, to a professional code of ethics that generally appears not very restrictive as regards aggressive tax planning schemes.

1.3.3 The tax administration

Aggressive tax planning schemes are a potential, considerable threat to the tax bases of governments around the world, which must thus adopt measures aimed at heightening the risks and costs stemming from failure by taxpayers and tax advisers to comply with the tax law.

According to Vito Tanzi, quoted earlier, "[i]f tax evasion is so high, the role of tax administration becomes doubly important. The size of tax administration resources, the main target groups (large enterprises or all taxpayers), the efficiency with which the resources are utilized (collection costs), the relation between the tax administration and the taxpayer (good public relations rather than the spreading of fear) and the methods of tax collection (withholding, presumptive taxes, minimum taxes and cross controls) all play a role in determining the level and lowering of tax evasion."[30]

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[30] *Supra*, note 26. In this quotation, the reasoning is based on tax evasion. For discussion purposes, we believe that it applies, with the necessary adjustments, to aggressive tax planning schemes.

We are unable to assess the magnitude of Canadian tax revenue losses resulting from domestic or international aggressive tax planning schemes carried out by individuals and businesses. However, it is possible to find statistical indicators from official sources that, while they are imperfect, suggest that numerous transactions are carried out for reasons that are hard to explain from a commercial standpoint. In the next section, we present various indicators, which, while they are not solely linked to aggressive tax planning schemes, suggest that such planning schemes have increased in recent years.

1.4 Quantitative assessment of the phenomenon

1.4.1 Statistical and other indicators

Table 1 provides data for Canada, drawn from the annual reports of the CRA and the Auditor General of Canada.

Table 1

- As noted earlier, in 1995-1996, even though the cost of income tax avoidance was unknown, Revenue Canada expected the tax avoidance program to lead to $365 million in reassessments.[31]
- For 1996-1997 Revenue Canada reported that its international tax programs generated total recoveries of $630 million.[32]
- In her 2001 report, the Auditor General noted that the CRA had identified 53 examples of the offshore spousal trust scheme that had moved over $800 million in capital gains to Barbados from Canada.[33]
- In 2004-2005, the CRA established assessments totalling roughly $1.2 billion in additional taxes stemming from adjustments of international operations, including transfer pricing.[34]

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31 *Supra*, note 11, par. 11.84.

32 Canada, *Report of the Auditor General of Canada*, December 1998, Chapter 24, "Revenue Canada—International Tax Directorate: Human Resource Management," par. 24.12.

33 Canada, *Report of the Auditor General of Canada*, 2001, Chapter 7, "Canada Customs and Revenue Agency—International Tax Administration: Non-Residents Subject to Canadian Income Tax," par. 7.88.

34 Canada, Canada Customs and Revenue Agency, *CCRA Annual Report to Parliament 2004-2005* [CRA, *Report to Parliament 2004-2005*], page 38.

- In 2004-2005, in cases involving tax planning abroad subject to an audit, the amount pertaining to taxes possibly at risk was estimated at $658 million.[35]

Aside from these statistical indicators, other types of indicators reveal that tax avoidance is a key concern among tax administrations. In fact, several countries have adopted concrete measures to better contain tax avoidance. Here are some examples of such measures adopted in Canada:

- April 2004: Canada, the United States, Australia and the United Kingdom signed a memorandum of understanding calling for the establishment of a multinational task force and a Joint International Tax Shelter Information Centre (JITSIC).[36]
- August 2005: the CRA established 11 Centres of Expertise to bolster and enhance its audit and recovery programs and to counter international tax avoidance, tax fraud and abusive international tax planning.[37]
- November 2005: the CRA launched the "Tax Alert!" initiative to strengthen measures aimed at combating aggressive tax planning.[38]

We will examine these measures in section 3 of this study.

The initiatives undertaken by the Canadian tax administration in respect of taxpayers' international transactions might, among other things, be motivated by the scope of such transactions in recent years. To this end, Tables 2 and 3 below reveal the marked change in recent years in direct Canadian investment abroad, especially in offshore financial centres (OFC) in the Caribbean.

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35 *Ibid.,* p. 39.

36 See Canada, Canada Revenue Agency, *Statement of Joint Cooperation Regarding Abusive Tax Transactions*, March 15, 2004. For an overview of these deliberations, see Gord Lawrence, "CRA Round Table: Joint International Tax Shelter Information Centre (JITSIC)," in *2005 Prairie Provinces Conference*, Toronto, Canadian Tax Foundation, pages 22:1-4.

37 Canada, Canada Revenue Agency, information document, "Aggressive International Tax Planning Centres of Expertise," August 2005.

38 Canada, Canada Revenue Agency, press release, "Revenue Minister John McCallum launches the Taxpayer Alert initiative," November 14, 2005. This strategy targets taxpayers who feel compelled to participate in aggressive tax planning schemes.

Direct investment abroad in OFCs is obviously not solely motivated by fiscal considerations but growth in this phenomenon is worrisome because these systems still lack transparency, thus increasing administrative costs and complicating the application of tax provisions by tax authorities of the country from which the investments originate.

Table 2

Direct investment[39] from Canada in the principal offshore financial centres (OFCs),[40] 1987-2003 (millions of dollars)			
	Average, 1987-1991	**Average, 1999-2003**	**Growth (%)**
Barbados	1,351	23,136	1613.7
Ireland	1,173	11,763	903.1
Bermuda	1,769	9,823	455.2
Bahamas	1,872	7,738	313.4
Cayman Islands	143	6,827	4,674.4
Hungary[41]	2	6,807	340,240.0
Source: Department of Foreign Affairs and International Trade, *Sixth Annual Report on Canada's State of Trade,* Chapter 5, April 2005.			

Table 3 presents for the most recent year available the fiscal value of direct Canadian investment abroad, in the United States and the United Kingdom and in OFCs, and establishes the rank of the country concerned.

39 Statistics Canada defines direct investment as an investment that allows the investor to exercise significant influence (an investor who possesses 10% or more of the voting securities of an enterprise is in a direct investment relationship) over the management of an enterprise that operates abroad.

40 Statistics Canada uses the definition and list proposed by the International Monetary Fund (IMF). According to this definition, an OFC is a jurisdiction that meets the following criteria:
- possesses a high number of financial institutions;
- a majority of the transactions are initiated abroad;
- a majority of the institutions are controlled by non-residents;
- possesses assets and liabilities that are disproportionate to the domestic economy; and
- offers low or zero taxation, flexible financial legislation and bank secrecy.

41 Although the IMF does not consider Hungary to be an offshore financial centre, the country does have an offshore tax regime. The strongest period of growth in direct investments in Hungary has occurred since the early 2000s.

Table 3

Direct Canadian investment in the world, including the United States, the United Kingdom and OFCs[42] and rank, 2004 (in millions of Canadian dollars)		
Country	**Direct Canadian investment**	**Rank (2004)**
All countries	445,063	N.A.
United States	193,855	1
United Kingdom	43,991	2
Barbados	30,595	3
Ireland	20,564	4
Bermuda	11,749	5
Cayman Islands	9,544	10
Bahamas	8,618	13
Switzerland	4,656	16
Singapore	3,790	19
Hong Kong	2,899	21
Channel Islands	X	X
Luxembourg	1,092	28
Malaysia	651	33
British Virgin Islands	582	37
Panama	146	51
Cyprus	108	56
Netherlands Antilles	86	58
Costa Rica	82	59
Belize	X	X
Mauritius and Dependencies	10	65
St. Lucia	X	X
Antigua and Barbuda	X	X
Malta	X	X
Aruba	X	X
Seychelles	X	X
Bahrain	X	X
Macau	X	X
X: confidential data		
Source: Statistics Canada, CANSIM Table 376-0051, May 2005.		

[42] The IMF identifies 42 jurisdictions that engage in offshore activities. In 2003, Canadian enterprises held assets in 25 of these jurisdictions.

According to Statistics Canada,[43] between 1990 and 2003, Canadian assets in OFCs increased eightfold, from $11 billion to $88 billion. The average annual growth rate of direct Canadian investment was higher in these countries (+18%) than in the United States (+8%) and in other countries (+14%). It has also been noted that these centres accounted for over one-fifth of all direct Canadian investment abroad in 2003, double the proportion 13 years earlier. In fact, the proportion of assets held in OFCs reached 22% in 2003, as against 11% in 1990.

[43] Canada, Statistics Canada, François Lavoie, "Canada Direct Investment in 'Offshore Financial Centres,'" March 2005, page 3.

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The stakeholders

In this section, we examine the profiles of and risk management by the stakeholders that we identified earlier in the realm of aggressive tax planning schemes. Given the universality of the problems linked to such planning schemes, the profiles of stakeholders and their management of risk from one country to the next may be generally similar, subject to regional characteristics. For the sake of simplicity, this section presents observations drawn from the literature in the jurisdictions selected for the study.

2.1 Taxpayers

In Canada, the CRA established the Compliance Research and Strategic Analysis branch several years ago, which conducts research and multidisciplinary analyses concerning the factors that define tax compliance behaviour. Until a report dealing more specifically with this aspect is published, research conducted elsewhere has attempted to establish the reasons that encourage taxpayers to resort to aggressive tax planning schemes, present the profile of such taxpayers, and describe their behaviour in the face of inherent financial risks.

2.1.1 Motives underlying aggressive tax planning schemes

2.1.1.1 Individuals

> A fundamental result of the tax evasion literature is that it remains a mystery why people actually pay taxes, given the rather low levels of fines and auditing probabilities. The deterrence model of tax evasion cannot explain the high tax compliance rates without referring to tax morale.[44]

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[44] Lars P. Feld and Bruno S. Frey, "Illegal, Fattening or What? How Deterrence and Responsive Regulation Shape Tax Morale," August 2004, page 22.

According to numerous sociological studies, it appears that individuals who elaborate or benefit from aggressive tax planning schemes generally do so for economic or psychological reasons. These grounds may be attributable to a multitude of factors specific to each individual, e.g. his personal values, social status, age, sex, general knowledge, economic position, marginal tax rate or perception of the taxation system or tax authorities.[45]

The taxpayers' interest in complying with the taxation system could thus depend, among other things, on their sense of civic duty and their trust in people like them and government authorities.[46] To this end, Professor Slemrod notes that "… many non-economist scholars, and some economists, argue that evasion choices made by individuals involve more than a cost-benefit calculation, and reflect the taxpayer's sense of duty, perception of the fairness of the tax system and trust in government and the political system more broadly."[47]

Moreover, a study conducted in the United States revealed that individuals considered tax evasion to be a less serious crime than accounting fraud, violation of labour standards that protect children, or insider trading. The level of importance attached to tax evasion was similar to that in respect of violations of laws governing social welfare and the minimum wage.[48] In light of these observations on tax evasion, individuals arguably do not necessarily deem the implementation of aggressive tax planning schemes to be wrong.

2.1.1.2 Businesses

It is harder to define how businesses perceive the payment of tax, since they act through directors or executives, who must, on the one hand, perform their duties in the best interests of the business and, on the other hand, account to investors for their governance.

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45 Benno Turgler and Kristina Murphy, "Tax Morale in Australia: What Factors Shape It and Has It Changed Over Time?" (2004), Vol. 7, *Journal of Australian Taxation*, pages 298-335.

46 *Ibid.*, note 45.

47 Joel Slemrod, "The Economics of Corporate Tax Selfishness," *Working Paper 2004-8*, Office of Tax Policy Research, University of Michigan Business School, September 2004, page 8.

48 Stewart Karlinsky, Hughlene Burton and Cindy Blanthorne, "Perceptions of Tax Evasion as a Crime," (2004), Vol. 2, No. 2, *eJournal of Tax Research*, pages 226-240.

According to Professor Slemrod, "Little is known about how and why corporations differ among themselves in their aggressiveness regarding pushing the envelope of the tax law, and whether their behaviour would respond to initiatives designed to strengthen intrinsic motivation. It is plausible that this is affected by whether the managers view paying taxes as a civic virtue or duty, and so abusive corporate avoidance has an ethical dimension just as evasion does …"[49] Essentially, for businesses, we must ascertain how directors, executives and, as the case may be, shareholders perceive taxation. Do they regard it as a civic duty or as a simple business cost?

2.1.2 Profile of taxpayers and inherent risks

2.1.2.1 Individuals

2.1.2.1.1 Profile

Individuals who earn high incomes and who value social status seem to be the most likely to engage in aggressive tax planning schemes, in particular because they may be subject to higher tax rates than the general populace.[50]

According to an Australian study, individuals who resort to aggressive tax planning schemes usually display a defensive, defiant attitude towards the tax administration.[51] They apparently tend to think that the taxation system and its administration should be simplified.[52]

2.1.2.1.2 Risks

Generally speaking, individuals may avoid resorting to aggressive tax planning schemes if they believe that the tax administration is likely to audit them. Individuals who resort to such planning

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49 *Supra*, note 47, p. 9.

50 Kristina Murphy and Yuka Sakurai, "Aggressive Tax Planning: Differentiating Those Playing the Game From Those Who Don't," *Working Paper No. 25*, Centre for Tax System Integrity, Research School of Social Sciences, Australian National University, Canberra, October 2001.

It should be noted that, for various reasons, individuals earning low incomes also represent another group at risk for the tax administration.

51 Valerie Braithwaite, "Perceptions of Who's Not Paying Their Fair Share," (2003), Vol. 38, No. 3, *Australian Journal of Social Issues*, pages 335-362.

52 *Supra*, note 50.

schemes run the risk that the tax administration and, ultimately, the courts will cancel the tax benefits obtained through such schemes. By evaluating this risk, they must, in particular, weigh up the possibility of having levied on them, as the case may be, penalties and interest in addition to the tax assessed.

These individuals generally tend to retain the services of aggressive tax advisers.[53] Given the taxation system's complexity, the individuals may be influenced by their advisers' assessment of the risk. Depending on their risk tolerance, they may accept the planning schemes that advisers or aggressive promoters propose.[54]

2.1.2.2 Businesses

2.1.2.2.1 Profile

The profile of a corporation can be determined by the values and civic and social considerations of its directors, executives and shareholders who, depending on their perception of the taxation system and their interests, might decide to take advantage of aggressive tax planning schemes or adopt a more conservative attitude. It should be noted, in another context (that of evasion), that a study conducted among small and medium-sized American enterprises reveals that those that do not comply with the tax legislation are three times more likely to be headed by managers who under-state their personal income tax.[55] However, in our opinion no study has established such a link between the aggressive tax planning schemes of businesses and the management by their executives of personal incomes taxes.

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53 Yuka Sakurai and Valerie Braithwaite, "Taxpayers' Perceptions of Practitioners: Finding One Who is Effective and Does the Right Thing?," (2003), *46 Journal of Business Ethics*, pages 375-387.

54 *Ibid.*

55 Joel Slemrod, "The Economics of Corporate Tax Selfishness," *Working Paper 2004-8*, Office of Tax Policy Research, University of Michigan Business School, September 2004, page 15, in which he quotes the text by D. Joulfaian, "Corporate Income Tax Evasion and Managerial Preferences," Vol. 82, No. 4, *Review of Economics and Statistics*, November 2000, pages 698-701.

2.1.2.2.2 Risks

Businesses must determine their level of tolerance of risk stemming from aggressive tax planning schemes.[56] They must balance investors' economic interests in the business with the business's long-term interests. Below are several extracts from "Tax in the Boardroom," a study conducted by KPMG in 2005 concerning certain inherent risks for corporations in the current fiscal environment.

> "Tax has changed dramatically in recent years. Its public profile has become much more conspicuous, it has acquired moral, ethical and social dimensions that have never been discussed before and, for these reasons, the business management issues associated with tax have become more complicated, more subtle, more steeped in risk and much more challenging."[57].
>
> …
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> "Non-owner stakeholders, including governments, pressure groups and society at large, are becoming more strident in their demands on, and criticisms of companies. Boards are coming under growing pressure to oversee their tax affairs in ways that reconcile their obligations to shareholders with the expectations of other interested constituencies."[58]
>
> …
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> "Boards should recognize that although so-called "aggressive" tax planning arrangements are creating value for shareholders in the short-term, they may destroy value in the long term, regardless of their legality and business substance, by damaging the reputations in the eyes of the interested external parties of the companies that implement them, the executives who approve them and the advisers who devise them. Reputational damage of this kind can have very material consequences. If a company is on a fiscal authority "watch" list it could increase its tax risk and compliance costs …."[59]
>
> …
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> "Had such consequences been anticipated, the value of the short-term benefits of the aggressive tax planning arrangements, despite their legality and adherence with individual corporate risk tolerances, might have seemed less attractive. Companies have always had a duty to maximize shareholder value. In the past this has usually been seen to generate a consequential duty to minimize tax charges within the law.

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[56] Such risks increase in several instances depending on their routine transactions, local or international growth strategies, and the financial return that investors demand. They may be directly or indirectly linked to the administration of tax laws. PricewaterhouseCoopers, "Tax Risk Management," 2004, page 11.

[57] KPMG International, "Tax in the Boardroom," Discussion Paper, 2005, page 1.

[58] *Ibid.*, page 7.

[59] *Ibid.*, pages 7 and 8.

> This legal constraint is no longer sufficient in many people's eyes. Boards should recognize, when overseeing the design and monitoring of tax strategies and policies, that contemporary debates about governance, corporate social responsibility and ethics mean that even legal tax-minimization activity can generate reputational liabilities that can destroy shareholder value."[60]
>
> …
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> "It has become harder to strike the right balance between what is and is not industry preferred practice. In the past there was a clear distinction between legal tax avoidance and illegal tax evasion. The distinction remains clear in law, but has become blurred in the minds of governments, regulators and the public. So-called "aggressive avoidance" tax planning arrangements that utilize reliefs that critics call "loop-holes" have acquired what amounts to a quasi-illegal status. There are more variables to consider when evaluating tax planning and risk has consequently increased. Boards and senior management also need to fully understand the consequences from multiple perspectives (e.g. financial, legal, reputational, etc.) of not allowing the tax department to engage in legitimate tax planning.
>
> This is a major challenge for companies, their tax advisers and the fiscal authorities, not least because business is denied the legal and reputational certainty of tax treatment it needs, due to the high level of movement of boundaries separating acceptable from unacceptable practices."[61]

Moreover, the method of remunerating directors and executives might be a factor that encourages them to act according to interests that differ from those of the company.[62] For example, remuneration established according to the company's after-tax yield might encourage the directors and executives to enter into aggressive strategies.[63]

2.1.2.3 Particular nature of public corporations

It is important to emphasize that the involvement of directors and shareholders in the management of the company's risks may be limited in practice, especially in public corporations.[64] The tax departments in such companies play an important role in the development

[60] *Ibid.*, page 8.

[61] *Ibid.*.

[62] Jeffrey Owens, "The Interface of Tax and Good Corporate Governance," *37 Tax Notes International*, February 28, 2005, page 767.

[63] Joel Slemrod and Keith J. Crocker, "Corporate Tax Evasion with Agency Costs," *Working Paper 2004-7*, Office of Tax Policy Research, University of Michigan Business School, June 2004, page 5.

[64] *Supra*, note 52. Henderson Global Investors, "Tax, Risk and Corporate Governance: Findings from a Survey of the FTSE350," February 2005, page 7.

of aggressive tax planning schemes.[65] Moreover, the management by public companies of fiscal risks may differ from other companies as they must usually disclose to investors all of the important facts likely to affect the value of their securities, in accordance with securities regulations. In principle, they should indicate key risk factors that a reasonable investor would deem to be relevant and any risk that the investor's responsibility might extend beyond the price of the security. However, companies may be reluctant to disclose all of the information concerning tax aspects.[66]

Several measures elaborated by Canadian securities commissions following the adoption in the United States of the *Sarbanes-Oxley Act*[67] might affect tax practices of public companies. More specifically, these measures stipulate that public companies must transparently disclose information that, if it is omitted or improperly formulated, could change a reasonable investor's decision to buy, sell or hold the company's securities. Furthermore, the chief executive officer and the chief financial officer must attest that, to their knowledge, the annual financial statements and other financial information presented in the company's annual documents provide an accurate picture of its financial position.

However, these measures do not stipulate parameters that businesses must apply constantly to determine whether they may record with certainty amounts stemming from an aggressive tax

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65 Nanette Byrnes and Louis Lavelle, "The Corporate Tax Game: How Blue-chip Companies are Paying Less and Less of the Nation's Tax Bill," *Business Week,* Special Report, March 31, 2003. PricewaterhouseCoopers, "Tax Risk Management," 2004, pages 11-14.

66 Robert S. McIntyre and T.D. Coo Nguyen, "Corporate Income Taxes in the Bush Years," Joint Project of Citizens for Tax Justice and the Institute on Taxation and Economic Policy, September 2004.

A survey conducted by KPMG (KPMG Global Sustainability Services, "KPMG International Survey of Corporate Responsibility Reporting 2005," KPMG/Universeit van Amsterdam, page 30) on the social responsibilities that big multinational firms assume reveals that among those that publish a report in this respect, a small percentage (16%) discuss tax aspects. Another survey, conducted by Hendersen Global Investors among FTSE350 companies (Henderson Global Investors, "Tax, Risk and Corporate Governance: Findings from a Survey of the FTSE350, February 2005), revealed that, generally speaking, they are reluctant to disclose their management of tax risks, in particular because of uncertainty about legal obligations stemming from such aspects. Moreover, certain businesses have indicated that they include in their profits presented in the financial statements the amount of tax benefits derived from planning schemes only when it becomes certain that the tax administration does not oppose them.

67 *Sarbanes-Oxley Act* of 2002.

planning scheme. Canadian regulatory authorities are examining the appropriateness of introducing the parameters that American and international authorities are elaborating in this regard.[68] Essentially, a company should ascertain whether compliance by any aspect of its income tax returns exceeds a predetermined confidence threshold before recording with certainty an amount stemming from aggressive tax planning schemes.[69] Following the example of other standards governing the disclosure of financial information, a company that does not follow them could contravene these obligations and, as the case may be, the securities commission could impose the penalties stipulated by the law.

2.2 Tax professionals

Taxpayers often have recourse to the services of tax professionals to help them clarify their tax affairs or take advantage of their expertise in the realm of tax planning. Consequently, the integrity of such professionals and their level of ethics are a cornerstone of the smooth operation of our taxation system.[70] In this section of the study, we will examine the types, role and inherent risks for these professionals in the context of aggressive tax planning schemes. To conclude, we will briefly review the ethical and other standards applicable in Canada to tax professionals.

2.2.1 Type and role of tax professionals

Generally speaking, the work of tax professionals is twofold. On the one hand, their practice focuses on tax compliance, i.e. the preparation of income tax returns and arguments submitted to the tax authorities and, on the other hand, tax planning. Legal advisers and accountants usually play a key role in the elaboration of tax planning schemes. When they engage in each of these activities, the professionals are perceived to play a dual role, i.e. that of ensuring compliance

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68 Canadian Institute of Chartered Accountants, Accounting Standards Board, Decision Summaries, “Uncertain Tax Positions,” January 4, 2006.

69 See the standards proposed in the United States by the Financial Accounting Standards Board, Exposure Draft, “Proposed Interpretation - Accounting for Uncertain Tax Positions: An Interpretation of FASB Statement No. 109,” July 14, 2005.

70 Mortimer Caplin, “The Tax Lawyer’s Role in the Way the American Tax System Works,” *Tax Notes*, February 7, 2005, page 697.

with the tax rules and that of advising their clients in order to minimize their tax burden. These roles can be complementary or conflicting. In a country like Canada, where the autonomy and independence of professionals in relation to the State is a basic principle, the professional's first responsibility is thus loyalty to his client and not to the tax authorities.[71]

According to a recent study conducted by Australian researchers, there are three types of tax professionals, i.e. honest professionals who are completely impervious to risk, those who seek to reduce taxes cautiously, and those who are more creative or aggressive.[72]

As for tax consulting firms or tax departments in big companies, their centre of interest has shifted from passive compliance with the tax laws to active, aggressive tax planning.[73] Several authors are of the opinion that the departments have, generally speaking, in themselves become profit centres.[74] Moreover, a study conducted in 2001 among the directors of the tax departments of Fortune 1000 firms revealed that 46% of them deemed the effective tax rate applicable to the company to be the factor that underpins the tax department's objectives overall, while only 16% of them emphasized tax compliance. As for the leading factor used to assess a tax department's performance, 36% of the directors replied "the effective rate" and none of them answered "accuracy."[75]

While tax professionals are autonomous and may accept or refuse to venture into the aggressive tax planning scheme market, the fact remains that competition between professionals can sometimes affect their decision.[76] However, competition alone cannot explain tax professionals''

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71 Victor Thuronyi and F. Vanistendael, *Tax Law Design and Drafting*, International Monetary Fund, Volume 1, Chapter 5: Regulations of Tax Professionals, 1996.

72 *Supra*, note 50.

73 *Supra*, note 53, page 3.

74 Supra, note 47, page 11. See also Vanessa Houlder, "The Tax Avoidance Story as a Morality Tale: Corporate Social Responsibility: Does the Duty to Pay Taxes Rank with Social and Environmental Obligations?," *Financial Times*, London, November 2004.

75 *Supra*, note 73.

76 John Braithwaite, "Through the Eyes of the Advisers: A Fresh Look at High Wealth Individuals," *Working Paper No. 21*, Centre for Tax System Integrity, Research School of Social Sciences, Australian National University, Canberra, September 2001.

behaviour. The complexity of the tax laws, in particular, allows professionals to practice in a highly competitive framework,[77] all the more so as the exploitation of grey areas appears to be increasingly and widely accepted in the industry. In this respect, certain studies note that the income tax returns produced by tax professionals generally tend to contain more aggressive tax positions than those that the taxpayers themselves prepare.[78]

From the standpoint of supply and demand in respect of aggressive tax planning schemes, certain studies focusing on the development of the market for such schemes reveal that supply and demand are not necessarily independent. In fact, tax professionals may ask taxpayers to subscribe to the aggressive tax planning schemes that they elaborate, while taxpayers may ask tax professionals to implement such schemes.[79].

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77 *Supra*, note 53.

78 *Ibid*.

79 These studies focusing on professionals reveal that the latter regard clients to be the instigators of aggressive tax planning schemes. On the other hand, these studies also show that the majority of taxpayers appear to seek an adviser who will prepare the income tax return appropriately and honestly. Taxpayers appear to generally concur with cautious advice rather than aggressive advice. *Supra*, note 50.

Other research conducted in Australia and the United States maintains that the market for aggressive tax planning schemes is created by professionals. In this case, supply initiates a cycle that subsequently generates demand, thereby accelerating growth in the market. *Supra*, note 53. John Braithwaite, *Markets in Vice, Markets in Virtue*, USA, Oxford University Press, 2005.

2.2.2 Risk management by tax professionals

Whether tax professionals propose aggressive tax planning schemes may depend, among other things, on an assessment of the risks stemming from the sale of such schemes. The factors considered to evaluate such risk include the possibility of being subject to a third-party penalty, the risk of the client's being audited and ultimately assessed by the tax authorities, the risk of losing the client, and the risk of other professionals' voicing differing opinions on the proposed tax planning scheme.[80]

Tax professionals are very familiar with Canadian administrative machinery and know to what extent the risk for the clients of being audited are limited, above all if no specific information in the income tax return arouses the tax authorities' suspicion.[81]

2.2.2.1 Administrative penalties levied on third parties

As indicated in Information Circular 01-1,[82] no provision was made for an administrative penalty in respect of individuals who advised other individuals to file their income tax returns using false or misleading data or who turned a blind eye to false data provided by their clients for tax purposes prior to the coming into force in 2000 of third-party civil penalties. The circular specified that the CRA was committed to applying the penalties fairly, consistently and only when clearly justified.

These penalties are intended to deter tax professionals from making false statements or omitting information. They also seek to ensure compliance with the law by discouraging behaviour that leads to non-compliance. The penalty is $1,000 or, as the case may be, the amounts that the adviser may collect in respect of the planning scheme.

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[80] J. Haseldine, P. Hite, A. Al-Khoury, S. James, S. Toms, and M. Toumi-Mejia, "Tax Practitioners and Tax Compliance," in A. Lymer and D. Salter, *Contemporary Issues in Taxation Research*, 2003, pages 17-43.

[81] Robert S. McIntyre, "Tax Cheats and Their Enablers," *Economic Policy Institute Tax Enforcement Forum*, Citizens for Tax Justice, April 12, 2005.

[82] Canada, Canada Revenue Agency, Information Circular 01-1, "Third-Party Civil Penalties," September 18, 2001.

The provisions pertaining to these penalties do not stipulate precise parameters to determine whether a tax opinion concluding that the anti-avoidance rules might not apply can be considered a false declaration or reckless disregard in respect of the law. The advisers might then provide a minimally reasonable position to support an aggressive tax planning scheme, based on the terms of the law, and thus minimize the risks to which they and their clients expose themselves by implementing a planning scheme.[83]

It is surprising to note that since its introduction and until August 31, 2005, the possible application of these penalties was analysed in only 13 cases. However, the CRA had not indicated whether these cases involved anti-avoidance rules, although one of the cases now being audited focuses on the promotion of aggressive tax planning schemes.[84] It should be noted that the CRA does not make provision for the application of penalties to advisers who participate in planning schemes covered by the anti-avoidance rules, unless they have submitted false declarations or their opinion contradicts the established jurisprudence.[85] In the absence of the application of the penalty, its deterrent effect from the standpoint of aggressive tax planning schemes is mitigated.

2.2.2.2 Contingency fee

When the remuneration of a professional for the elaboration and implementation of a planning scheme makes provision for a contingency fee, the challenging by the tax authorities of such a scheme could affect the professional's profit. In Canada, accountants and lawyers may have recourse to contingency fees.[86] However, chartered accountants may not receive such fees if

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83 For an analysis of the application to advisers of penalties in conjunction with an aggressive tax planning scheme, see Steve Cook and Terry Gill, "Potential Civil And Criminal Liability of Promoting Tax Avoidance Products," *2005 Prairie Provinces Conference*, Toronto, Canadian Tax Foundation, pages 19:1-19:36.

84 Canada, Canada Revenue Agency, *Income Tax – Technical News*, No. 34, April 27, 2006, page 13.

85 *Supra*, note 82, par. 77.

86 Article 215 of the *Code of Professional Conduct* of the Canadian Institute of Chartered Accountants and article 16 of Resolution 04-01-A amending comment 10 in Chapter XI of the *Code of Professional Conduct* adopted by the board of the Canadian Bar Association in August 1987.

doing so can influence their judgement in conjunction with an audit.[87] Recourse to this type of remuneration could be an incentive for the clients to undertake an aggressive tax planning scheme.

2.2.2.3 Reputation

Because of recent financial scandals and the collapse of one of the biggest accounting firms in the United States, reputation has become an important factor in tax practice.[88] Reputation affects the clientele and also relations with the tax authorities. For professionals to adopt very aggressive stances or even elaborate aggressive tax planning schemes might put at risk their reputation and even their business.

One way for a tax professional to maintain his reputation is to adopt certain ethical standards in conjunction with his practice and abide by them.

2.2.2.4 Ethics and professional standards

Ethics is a vast concept whose ins and outs cannot be clearly established. Professionals must abide both by a professional code and a personal code while ensuring that they satisfy their clients' expectations. These obligations are sometimes incompatible.[89] The professional may, to varying degrees, be compelled to give higher priority to one of the obligations to the detriment of the others.

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87 Section 215 of the *Code of Professional Conduct* of the Canadian Institute of Chartered Accountants. The *Code of Ethics of Chartered Accountants,* R.R.Q., 1981, c. C-48, r. 2, of the *Ordre des comptables agréés du Québec* makes similar provisions in sections 59.1 to 59.4.

88 In the United States, the Chief Accountant of the US Securities and Exchange Commission recently emphasized that questions of income tax are under public scrutiny and this situation will very likely endure in the future. Donald T. Nicolaisen, "Speech by SEC staff: Remarks at the Tax Council Institute Conference on The Corporate Tax Practice: Responding to the New Challenges of a Changing Landscape," Washington, DC, February 11, 2004 (available online at: www.sec.gov/news/speech/spch021104dtn.htm).

89 Yuka Sakurai and Valerie Braithwaite, "Taxpayers' Perceptions of the Ideal Tax Advisers: Playing Safe or Saving Dollars?," *Working Paper 5*, Centre for Tax System Integrity, Research School of Social Sciences, Australian National University, Canberra, May 2001, p. 3.

In their practice, professionals establish standards more or less formally to structure their activities. These unofficial standards may describe what constitutes "best practices" in the performance of their duties or, at the very least, correspond to compliance with a minimal standard that usually should be surpassed.[90] Professionals thus work partly according to their own ethical standards, which are determined, among other things, by their level of tolerance to risk.[91]

Some authors maintain that the standards should emerge from what the professionals deem to be ethical or at least be underpinned by it.[92] However, when professionals attempt to abide solely by minimal standards, the perception of the status of a professional is diminished and the practice can be described simply as commercial as opposed to professional.[93]

To enhance the ethical standards of professionals, the professional boards that are responsible for regulating certain professions usually adopt practice standards through their respective codes, which all of their members must follow, regardless of their field of practice.[94] For example, the *Code of Professional Conduct* of the Canadian Bar Association does not make provision for specific standards in respect of tax planning. Generally speaking, this code stipulates that a lawyer may not act fraudulently or dishonestly and may not recommend that a client act in this manner.[95] The code of professional conduct of the *Barreau du Québec* makes similar

90 Frank J. Gould, "Giving Tax Advice – Some Ethical Professional and Legal Considerations," *Tax Notes*, October 2002, page 523.

91 *Supra,* note 90, page 525.

92 *Supra,* note 90, page 529.

93 Frank J. Gould, "Enron and the Boundaries of Aggressive Tax Advice," Vol. 82, Issue 7, *Taxes*, Chicago, July 2004, page 25.

94 In Canada, professionals are regulated by their professional association and the government thus does not intervene directly to establish standards. Self-regulation is a prerogative of the professions, although it is not impossible that this privilege may be wholly or partly withdrawn.

95 *Code of Professional Conduct* of the Canadian Bar Association, Chapters I and III.

provisions.[96] It should be noted that this code was recently amended to impose on advisers an obligation to indicate to the client any fact that may constitute a violation of a rule of law.[97]

However, the context of tax practice, e.g. economic risks and the risk of reputation damage for professionals, competition, relatively low penalties, and the complexity of the legislation, affect the level of ethics in this field.[98] Because of the difficulty of delineating the notion of ethics in the realm of taxation, professional organizations might establish standards adapted to this discipline to help professionals manage these occasionally contradictory obligations. This would undoubtedly enhance the general level of tax compliance.[99] The establishment by professional organizations of specific standards would strike a better balance between the loyalty that the advisers must display towards their clients and their attitude towards the tax administrations.[100]

In this respect, we note that governments have adopted measures in recent years to restrict the possibility for advisers to render professional services to certain clients in respect of whom another person in the same firm is responsible for an audit engagement (and a review engagement, subject to exception) if this can significantly affect financial statements.[101] A great deal has been written lately about the independence of auditors since it is a key foundation of the security of and trust in financial markets, which are threatened by certain behaviour, including aggressive tax planning schemes.

To maintain their members' independence in their practice, professional boards could develop ethical standards in tax matters in keeping with those adopted by governments in the financial sector.

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96 *Code of ethics of advocates*, R.R.Q., 1981, c. B-1, r.1, Barreau du Québec [*Code of ethics of advocates (Québec)*], sections 2.01 and 4.02.01 f) and g).

97 *Supra*, section 3.05.18 added by O.C. 351-2004, April 7, 2004, *Professional Code*, R.S.Q., c. C-26.

98 *Supra,* note 90, page 525.

99 *Supra,* note 89, page 22.

100 *Supra*, note 71.

101 *Code of ethics of advocates (Québec)*, *supra* note 96, section 3.05.19 added by O.C. 351-2004, April 7, 2004, *Professional Code*, R.S.Q., c. C-26.

2.3 The tax administration

2.3.1 Profile

Unlike the first two stakeholders mentioned in sections 2.1 and 2.2, who benefit from aggressive tax planning schemes, the third stakeholder, the tax administration, seeks instead to implement tools to define such planning schemes, among other things in order to enhance financial risks for the taxpayers and advisers participating in them. Before we focus in greater detail on certain of these tools in section 3 of this study, we will examine in the subsection below the risks inherent in this type of tax planning scheme with which the tax administration and the courts must contend.

2.3.1 Inherent risks

The tax administration has identified aggressive tax planning schemes as one of the key risk factors in the execution of its mandate[102], and claims that they undermine the integrity of the tax legislation and erode the tax base.[103]

Since 2001, the CRA has focused on this risk of erosion of the tax base. In 2005, to support the CRA's efforts, the Department of Finance Canada increased its audit and execution budget by $30 million a year to discourage the implementation of international aggressive tax planning schemes, based on an approach centred on the risk of the loss of tax revenues.[104] The Department of Finance is of the opinion that the additional tax revenues that the tax administration will collect through the adoption of such measures will offset their costs, although it has not given a precise estimate in this respect.

From the standpoint of reducing the risks of the erosion of the tax base, the tax administration thus intends to:

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[102] CRA, *Annual Report to Parliament 2004-2005*, *supra* note 34, page 34.
[103] CRA, *Business Plan 2005-2008*, *supra* note 29, page 17.
[104] Canada, Department of Finance Canada, *The Budget Plan 2005*, page 485.

- broaden early detection of tax avoidance schemes;
- enhance risk assessment and audit programs;
- heighten awareness among taxpayers and advisers of unacceptable measures;
- recommend legislative amendments; and
- pursue cooperation with other countries in tax matters.[105]

2.4 The courts

2.4.1 Profile

The courts are called upon to settle disputes between taxpayers and the tax administration concerning the interpretation of the law and the application of the law to an aggressive tax planning scheme.

Depending on the scope of the courts' rulings, taxpayers, tax professionals and the tax administration may want to apply them to other contentious aggressive tax planning schemes. The court rulings thus have significant repercussions on the management by the stakeholders of the risks inherent in aggressive tax planning schemes.

2.4.2 Inherent risks

When the law does not clearly distinguish between acceptable and abusive tax planning schemes, the court must then attempt to make such a distinction as accurately as possible to properly describe the planning scheme in dispute. To this end, it may take into consideration the importance that the law attaches to the principle of predictability for the taxpayer concerning the application of the law and the principle of the integrity of the taxation system, in light of the provisions that it examines. Depending on the degree of uncertainty, there is then a risk that one of these principles will take precedence over the other in light of the circumstances.

[105] *Supra*, note 103, pages 25-26.

The court must also ensure that the tax administration does not overstep the audit authority that the law confers on it. It must evaluate the risk of the tax administration's infringing the rights and privileges that the law confers on taxpayers, depending on the circumstances submitted to it. The possibility for the tax administration to collect all of the relevant information then depends, to some extent, on recognition by the courts of the taxpayers' rights and privileges, and their obligations.

3

Tool available to the Canadian tax administration to define and curb aggressive tax planning schemes

As mentioned in section 2.3, the tax administration is very likely seeking to implement tools to remedy problems stemming from aggressive tax planning schemes with which it is confronted. This section will describe several of these tools and the difficulties that their implementation poses for stakeholders. To this end, we have divided the tools selected into the following categories:

- anti-avoidance rules;
- awareness resources;
- monitoring tools;
- information requests during an audit;
- penalties for misleading information.

3.1 Anti-avoidance rules

Generally speaking, the specific anti-avoidance rules and the GAAR seek to rescind the tax benefits that taxpayers derive from aggressive tax planning schemes that are considered abusive. While these rules do display similarities,[106] their scope differs. A specific rule seeks to withdraw the tax benefits stemming from a specific planning scheme. On the other hand, the GAAR applies if the tax avoidance scheme leads to the abuse of one of the provisions or of the law read as a whole.

The efficacy of the anti-avoidance rules depends, first and foremost, on the distinction that they succeed in establishing between acceptable planning schemes and those deemed to be abusive.

[106] By way of illustration, see the comparison of the terms of a specific anti-avoidance rule and the GAAR conducted by the Tax Court of Canada in the *Univar Canada* v. *The Queen* case, 2005 TCC 723.

First, the specific rules precisely delineate planning schemes that are deemed to be abusive. However, these rules raise interpretation problems when they are drafted in general or vague terms or when they do not uniformly reflect the purposes of the Act. Moreover, problems of uncertainty concerning the scope of a rule arise during the time that may elapse between the date of the coming into force of a rule and the adoption of the law that gives effect to it. In these cases, they establish a vague distinction between the aggressive tax planning schemes that should be considered acceptable and those that should be regarded as abusive, according to the purpose of the law. Second, the difficulty of distinguishing between acceptable and abusive tax planning schemes is accentuated by simultaneous reliance on the specific rules and the GAAR. Like the specific rules, the GAAR poses interpretive problems from the standpoint of its application criteria. Among the problems is the uncertainty in the jurisprudence surrounding the use of an alternative scenario to establish the existence of a tax benefit or tax avoidance transaction This uncertainty mitigates the predictability that taxpayers seek in the conduct of their affairs.

Generally speaking, the anti-avoidance rules seek to deter taxpayers and tax advisers. However, such rules only act as a deterrent once they have come into force. They do not rescind tax benefits stemming from planning schemes implemented prior to that time. The GAAR makes it possible to remedy these difficulties, although subject to the uncertainty that remains concerning its scope and application. It should nonetheless be noted that the lack of penalties on the amount of the tax benefit rescinded by the anti-avoidance rules very likely mitigates their deterrent effect. The deterrent effect of such rules also depends, to a large extent, on the degree of uniformity with which the tax administration and, in particular, the courts, apply these rules.

Vigorous application by the tax administration of the anti-avoidance rules could bolster the deterrent effect and lead to settlements with the taxpayers concerned. Such settlements allow both parties to better manage their risks in relation to lengthy, costly, and unpredictable litigation. Settlements enable the tax administration to collect additional revenues and to avoid the risk of the courts' handing down rulings that might be unfavourable to it and might subsequently benefit all taxpayers. The interest for taxpayers to reach a settlement depends on their assessment of the risk of the courts' upholding the tax administration's position.[107]

In 2005, the Supreme Court of Canada spelled out the application principles of the GAAR[108] that might also apply to the specific anti-avoidance rules, with appropriate modifications. These principles are intended to structure disputes concerning the application of the anti-avoidance rules, under the assumption that Parliament is seeking uniformity, predictability and fairness in tax matters as much as countering abusive tax planning schemes.[109] Briefly, below are the highlights of certain of these principles:

- the taxpayer must demonstrate that no tax benefit stems from a transaction and that the transaction is not a tax avoidance transaction. If he succeeds in demonstrating the absence of a tax benefit or a tax avoidance transaction, the tax administration must then be able to establish their existence. The tax administration could demonstrate it by submitting an alternative transaction that would have enabled the taxpayer to achieve the same outcome as the transaction carried out, but without the tax benefit;
- the tax administration must establish that the aggressive tax planning scheme undermines the law in an abusive manner.

The tax administration's burden of proof may be hard to bear since the tax rules may not necessarily reflect a uniform fiscal policy.[110] The consequences may thus be serious for the tax

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107 The risk of going to court in tax avoidance cases may be high. A taxpayer may appeal his case before the Tax Court of Canada if the tax administration does not respond to his notice of objection within 90 days. However, in cases involving aggressive tax planning schemes, the CRA cannot reasonably process the taxpayers' notice of objection within the prescribed time. In Canada, *2004 November Report of the Auditor General of Canada,* Chapter 6, "Canada Revenue Agency – Resolving Disputes and Encouraging Voluntary Disclosures," November 2004, pages 8-9, it is emphasized that the CRA, for 2003-2004, had determined that a time limit of 195 days to process an objection in a tax avoidance case would be reasonably necessary and that it had attained the objective in 81.6% of cases.

108 *Supra*, note 21, par. 63-66.

109 *Ibid.*, par. 36-45.

110 See *Canada Trustco, supra* note 20. Mention should also be made of the opinion expressed by the Tax Court of Canada in *Evans* v. *The Queen*, 2005 TCC 684, par. 33, concerning the application of the GAAR to such a planning scheme. In that case, a shareholder carried out a planning scheme by relying on various provisions to withdraw the profits from his company by means of capital gains instead of dividends. The tax administration assessed the taxpayer on the grounds that this planning scheme was abusive and that the amounts he had

administration, since the courts might rule in favour of the taxpayer if there is any doubt about the purpose of the law alleged by the tax administration to justify the application of the anti-avoidance rules.

The principles elaborated by the Supreme Court of Canada have established the parameters of application of the anti-avoidance rules but have not necessarily dissipated all of the uncertainty surrounding their application. In the absence of detailed parameters, the courts have, in subsequent rulings, taken into consideration various elements depending on the circumstances, ranging from economic substance[111] to the taxpayer's intention[112] to determine whether a planning scheme was abusive.

3.2 Awareness resources

In November 2005, the CRA launched the "Tax Alert!" initiative,[113] to bolster its efforts to combat international aggressive tax planning schemes. Taxpayers thus have access to centralized information and notification services on various topics, including tax shelters, tax havens and tax avoidance schemes.[114]

Certain taxpayers and advisers could decide that it is too risky to implement tax planning schemes similar to those identified by the CRA in a public news release or on its Website. Nonetheless, this will not, arguably, prevent taxpayers and advisers from pursuing other

received in the wake of the planning scheme should be taxed in the form of dividends. Justice Bowman rejected the argument raised by the tax administration: "The only basis upon which I could uphold the Minister's application of section 245 would be to find that there is some overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends, and where they are not the Minister is not permitted to ignore half a dozen specific sections of the Act. This is precisely what the Supreme Court of Canada has said we cannot do." See also the ruling in *Lipson* v. *The Queen*, 2006, TCC 148.

111 On the evaluation of a planning scheme in light of its economic substance in the context of the anti-avoidance rules, see par. 58-60 and 76 in *Canada Trustco*, *supra* note 20. See also *XCo Investments Ltd.* v. *The Queen*, 2005 TCC 655, a ruling handed down by the Tax Court of Canada on November 14, 2005.

112 See *Univar Canada* v. *The Queen*, 2005 TCC 723.

113 *Supra*, note 38.

114 *Supra*, note 23.

aggressive tax planning schemes, since the CRA is not necessarily able to identify all of them. This tool's efficacy must be measured in the coming years.

3.3 Monitoring tools

Taxpayers and, as the case may be, advisers, must register the tax shelters in which they participate. They must also file information returns on transactions carried out abroad, according to the requirements that the tax administration stipulates.

Moreover, the CRA is seeking to strengthen its planning scheme identification and analysis techniques, in particular by stepping up its collaboration with foreign tax administrations in countries that have signed a tax treaty with Canada.[115]

3.3.1 Registration of tax shelters

Generally speaking, persons who promote the sale of a tax shelter and those who act as advisers in respect of such a sale must obtain a registration number from the tax administration. The promoters must also maintain a list of purchasers, who must file with their income tax returns an information return indicating the registration number of the investment in order to claim the tax benefits.

Obtaining a registration number is only an administrative formality, one that does not confirm the tax benefits. However, promoters who do not obtain a registration number prior to the sale of the tax shelters are liable to a penalty that can reach 25% of the compensation that they may receive from the purchasers.[116] They are also liable to a fine of up to $25,000 if they fail to file the prescribed form containing information on the purchasers.[117] Moreover, failure by the

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[115] *Supra*, note 103, pages 25-26.

[116] Subsection 237.1(7.4) ITA.

[117] Subsection 238(1) ITA. Technically, the promoters could also be liable to a maximum prison sentence of 12 months.

promoters to register a tax shelter may mean that the purchasers are unable to claim the tax benefits.[118]

The registration of tax shelters has enabled the tax administration in recent years to take steps to curb tax shelters. It should nonetheless be emphasized that, according to a report of the Auditor General, the CRA does not automatically match the information provided by the promoters in the returns that they file with purchasers' income tax returns. The CRA is assessing the possibility of enhancing reliance on information returns in this respect to better manage risks related to tax shelters.[119]

3.3.2 Information returns on offshore transactions

Taxpayers must file with the tax administration information returns concerning their offshore transactions.[120] Parliament is seeking, among other things, to obtain additional information to better evaluate provisions in the Act governing such transactions. Information filings enable the tax administration to better target its audits. Moreover, these information returns can deter taxpayers from implementing aggressive tax planning schemes.[121]

Below are the main relevant CRA information returns:

- T106, Information Return of Non-Arm's Length Transactions with Non-Residents;[122]

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118 Subsection 237.1(6.1) ITA.

119 Canada, *2005 November Report of the Auditor General of Canada,* Chapter 3, "Canada Revenue Agency – Verifying Income Tax Returns of Individuals and Trusts," pages 16-17.

120 For non-arm's length transactions with non-residents (233.1 ITA); for assets located abroad (233.3 ITA); for transactions with foreign affiliates (233.4 ITA); for transactions with foreign trusts (233.2 ITA).

121 See the objectives expressed by the Department of Finance Canada concerning information returns in respect of foreign assets in Canada, *Report of the Auditor General of Canada to the House of Commons and to the Ministers of Finance and National Revenue,* "Examination of the requirement to report specified property under section 233.3 of the Income Tax Act," June 1998, par. 9, 12 and 18 and item 2 of the report.

122 Form T106 makes it possible to identify transactions with related entities. It is, therefore, broadly used to target transactions at risk from the standpoint of transfer pricing. It also makes it possible to verify compliance by taxpayers with other fiscal measures. Although form T106 measures exchanges with affiliates, it nonetheless provides little information on the operations abroad of affiliates. Forms T1134-A and T1134-B allow for better planning and enhanced efficacy as regards audits of multinational firms in respect of:

- the identification of investments in tax havens or elsewhere;

- T1135, Foreign Income Verification Statement;
- T1134-A, Information Return Relating to Foreign Affiliates That Are Not Controlled Foreign Affiliates;
- T1134-B, Information Return Relating to Controlled Foreign Affiliates;
- T1141, Information Return in Respect of Transfers or Loans to a Non-Resident Trust;
- T1142, Information Return in Respect of Distributions from and Indebtedness to a Non-Resident Trust.

As indicated in a report from the Auditor General in 2002, international information returns are useful to respond to concerns stemming from the inappropriate transfer of income to tax havens.[123] However, the report provides no detailed observation on their efficacy in containing aggressive tax planning schemes. Generally speaking, the report recommended enhancing the quality of information to assess the overall risks stemming from international transactions and better control the integrity of data from information forms on foreign assets.

The efficacy of these measures also depends on the consequences for taxpayers who do not provide all of the information requested in the information returns. The penalties levied on

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- the establishment of foreign accrual property income (FAPI);
- the establishment of surplus accounts pertaining to the deductibility of dividends from a foreign affiliate;
- the identification of the disposal of investments (capital gain);
- the organization of the group of corporations (organization chart);
- the financial statements of the foreign affiliate controlled;
- the identification of risks concerning transfer pricing in relation to management fees, royalties or the transfer of intangibles.

Without the T1134-A and T1134-B forms, it would be harder for the CRA to efficiently assign its staff to those cases that represent the greatest risks of non-compliance at the international level. The auditors of international transactions, especially in the realm of foreign accrual property income, thus appear to be subject to the vagaries of the regular selection of files.

[123] Canada, Report of the Auditor General of Canada, December 2002, Chapter 4, “Canada Customs and Revenue Agency: Taxing International Transactions of Canadian Residents,” par. 4.38 to 4.43. See also Chapter 11 of the same report, “Other Audit Observations,” page 35, in the section devoted to the Department of Finance Canada.

taxpayers when they provide false information or omit to provide information can enhance the efficacy of these tools.[124]

3.3.3 Centres of expertise

In August 2005, the CRA set up 11 Centres of Expertise, among other things to develop identification strategies in respect of abusive tax planning schemes.[125] These centres were established to pinpoint and better understand international tax avoidance and abusive international tax planning. They are located in Regional Tax Services Offices across Canada and bring together international tax administration auditors and tax avoidance officers.

According to the CRA, a preventive monitoring strategy will enable it to quickly bolster its risk management and clearly, promptly indicate its position in respect of such risks, compared with monitoring operations conducted solely in conjunction with audits.[126] The efficacy of the Centres of Expertise established must be measured in the coming years.

3.3.4 Joint International Tax Shelter Information Centre (JITSIC)

The Canadian tax administration has participated in the Joint International Tax Shelter Information Centre (JITSIC) since its inception in 2004, in collaboration with the American, Australian and British tax administrations. Briefly, the collaborating countries are seeking to exchange information on new aggressive tax planning schemes, their promoters and investors in such schemes. This collaboration will enable the tax administrations concerned to pinpoint and better understand aggressive tax planning schemes, on the one hand, and to enhance their execution activities in respect of such schemes, on the other hand.[127] Among the tools that the

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[124] Subsection 163(2.4) ITA. Briefly, these penalties correspond to the greater of $24,000 and an amount equivalent to 5% of the cost or value of the asset covered by the respective returns.

[125] *Supra*, note 37.

[126] Canada, Canada Revenue Agency, *Future Directions for the Canada Customs and Revenue Agency - Large Businesses*, RC 4312.

[127] *Supra*, note 36.

centre intends to develop, mention should be made of the establishment of a portal to inventory aggressive tax planning schemes and dormant companies.[128]

3.4 Information requests during an audit

Generally speaking, auditors in each tax office must detect the risks of tax avoidance in the files that they process.[129] The CRA intends to focus most of its audits on high-risk sectors,[130] including aggressive tax planning schemes.[131]

In this respect, the tax administration can develop tools to enhance the tracking of aggressive tax planning schemes during audits of a taxpayer's affairs. To bolster such tracking, the CRA is enhancing staff training and assigning greater numbers of local auditors both to ongoing international audits and to targeted projects involving foreign administrations.[132] This tracking will allow it to more accurately ascertain the additional information that it should obtain to apply the anti-avoidance rules.

In addition to verifying the taxpayers' books, registers and information returns, the tax administration may demand taxpayers and, as the case may be, advisers, to submit information to it on demand during an audit, subject to the application of the solicitor-client privilege [133] concerning the information requested.

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128 Louis J. Provenzano and Sheryl Mapa, "CRA on Aggressive Planning," (2006), Vol. 14, No. 2, *Canadian Tax Highlights* 1.

129 The auditors are divided into four main groups of taxpayers, i.e. big businesses, small and medium-sized enterprises, individuals and charitable organizations, according to a risk management system: see the *Future Directions* initiative that the CRA launched in April 2001. Certain auditors in these groups deal primarily with tax avoidance questions. See Patrick Boyle *et al.*, "The GAAR Committee: Myth and Reality," *2002 Conference Report*, page 10:2. W. Szyc, "Tax Avoidance Matters," June 27, 2000, Vol. 8, No. 6, *Canadian Tax Highlights*, Toronto, Canadian Tax Foundation. The announcements made since 2004 suggest that the number of auditors should increase in the coming years.

130 Canada, Canada Customs and Revenue Agency, *CCRA Annual Report to Parliament 2003-2004*, page 1-31.

131 CRA, *Annual Report to Parliament 2004-2005, supra* note 34, page 34.

132 *Supra*, note 37.

133 Subsection 232(1) ITA stipulates that this privilege applies to lawyers and notaries in Québec and to barristers and solicitors elsewhere in Canada.

More specifically, the Tax Avoidance Program, which encompasses the GAAR Committee, assists the auditors in identifying aggressive tax planning schemes during audits. The auditors must submit their files involving aggressive tax planning schemes to the GAAR Committee, which then formulates its recommendations to ensure uniform application of the GAAR.[134]

These tools enable the tax administration to increase its chances of detecting aggressive tax planning schemes during audits. They also allow it to make practical use of information derived from the preventive monitoring tools mentioned earlier, such as the Centres of Expertise and the JITSIC. The efficacy of these measures must be evaluated in the coming years.

3.4.1 Requirements

Briefly, the tax administration is empowered to demand taxpayers or any other person information that might prove relevant to the application of the law. Those who fail to comply with a requirement are liable to legal consequences ranging from monetary penalties to imprisonment.[135] The courts are called upon to ascertain the validity of a tax administration's request for information from the taxpayer or any other person.[136]

The courts are of the opinion that the auditors may ask taxpayers to file information located abroad concerning their aggressive tax planning scheme and any other person when this information is located in Canada, insofar as the information may be relevant to determine whether the planning schemes amounts to an abuse of the law.

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[134] For an explanation of the nature and functioning of the committee, see Patrick Boyle *et al.,* "The GAAR Committee : Myth and Reality," *2002 Conference Report*, 10:1-10:20. A section of this program is devoted to identification, detection and coordination in order to communicate the necessary legislative amendments to the Department of Finance: see Canada, *Report of the Auditor General of Canada,* May 1996, Chapter 11, "Revenue Canada—Combatting Tax Avoidance," par. 11.12 to 11.19.

[135] Parliament also established that a taxpayer residing in Canada may not submit in evidence before the courts information located abroad that he has not submitted on request to the tax administration. (See 231.6(8) ITA.)

[136] The tax administration may demand a person to provide any information that may prove relevant for the application and execution of the law, including the collection of an amount payable by a taxpayer. It must, however, be authorized by the courts to obtain from a person information concerning other persons that the tax administration cannot precisely identify but who are nonetheless identifiable.

When the tax administration audits a taxpayer's affairs, it may, in particular, demand that another person, such as another taxpayer or an adviser, provide information on the purposes that the person is pursuing in an aggressive tax planning scheme.[137] If the tax administration wishes to audit taxpayers who are not personally identified but who are identifiable, it must obtain the court's authorization to request that another person file information on aggressive tax planning schemes that concern the person.[138]

In the wake of the recommendations of the Auditor General,[139] the auditors would focus more extensively on the filing of information by taxpayers and advisers, whether such information is located in Canada or abroad.[140] Moreover, advisers have already observed that auditors are relying more frequently on questionnaires dealing with the facts and the taxpayers' interpretation of the law.[141]

The efficacy of requirements depends on the consequences for taxpayers in case of non-compliance. Non-compliant persons will usually be subject to the monetary penalties stipulated by the law. The taxpayers could, nonetheless, submit as evidence the information that was not filed with the tax administration in an attempt to overturn the application of the anti-avoidance rules, except if the information is located abroad.[142] In the latter instance, under exceptional circumstances the courts would allow the information to be submitted as evidence, in particular

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137 *Fraser Milner Casgrain LLP* v. *Minister of National Revenue*, 2002 DTC 7310 (FC).

138 *Redemeer Foundation* v. *Minister of National Revenue*, 2005 DTC 5617 (FC).

139 In 2002, the Auditor General recommended to the CRA that it resort more extensively to requirements to file information located abroad. Canada, *Report of the Auditor General of Canada*, Chapter 4, "Canada Customs and Revenue Agency: Taxing International Transactions of Canadian Residents," December 2002, par. 4.38 to 4.43. The CRA indicated that it was seeking to establish a process to facilitate recourse to this measure.

140 Howard J. Kellough, "Information Requirements and Privilege Under the Act," *2003 British Columbia Conference*, Toronto, Canadian Tax Foundation , pages 2:1-2:23; Mara Praulins and Janice McCart, "Transfer-Pricing Audits: Emerging Issues," *2003 Conference Report*, Toronto, Canadian Tax Foundation, pages13:1-13, pages 13:10-11.

141 François Auger, "Droits et obligations du contribuable et de ses représentants et usage et impact des questionnaires rédigés par les autorités fiscales," *Colloque 145 : Techniques de vérification et d'enquête*, Montréal, Association de planification financière et fiscale du Québec, 2004.

142 Pursuant to section 231.6 ITA, a taxpayer may not submit as evidence before the courts information located abroad that he has not submitted on request to the tax administration. However, the courts might nonetheless allow the taxpayers to submit the documents if the tax administration's request was unreasonable: see *Saipem Luxembourg S.V.* v. *Canada Customs and Revenue Agency*, 2005 DTC 5348 (FCA).

if this prohibition creates an injustice in respect of the taxpayer.[143] Moreover, the tax administration may not obtain information that is protected by the solicitor-client privilege.

3.4.2 Convention on Mutual Administrative Assistance in Tax Matters

Besides, the auditors might resort to the information exchange mechanisms stipulated in tax treaties in order to collect information on international tax planning schemes. It should be noted that the signing by Canada in April 2004 of the *Convention on Mutual Administrative Assistance in Tax Matters* affords auditors an additional tool to obtain relevant information on aggressive tax planning schemes when they audit a taxpayer's affairs, mainly multinationals.[144]

Elaborated by the Council of Europe and the OECD in 1988,[145] this treaty seeks essentially to develop international cooperation to ensure better application of domestic tax legislation in a spirit of respect for the basic rights of taxpayers. It thus makes provision for all possible forms of administrative cooperation between States as regards the establishment and recovery of taxes, in particular with a view to combating aggressive tax planning schemes and tax evasion.[146]

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[143] *Glaxo SmithKline Inc.* v. *The Queen*, 2003 DTC 5318 (TCC). This might occur if the tax administration exercise its power in an abusive manner, in particular if it demands the filing of a substantial volume of documents that are not reasonably identifiable. The courts can hardly determine whether each of thousands of documents is subject to an information request. Under exceptional circumstances, the courts might allow the taxpayers to submit as evidence documents that they have not submitted on request to the tax administration, in order to prevent injustice. It should be noted that the court pointed out that the prohibition on submitting as evidence unfiled documents, depending on the circumstances, could undermine the taxpayers' right to a fair, impartial hearing according to the principles of fundamental justice.

[144] Canada, Canada Revenue Agency, press release, "Canada Signs International Tax Convention," April 29, 2004. It should be noted that the English version refers to "tax avoidance and tax evasion" while the French version uses the expression "évasion et fraude fiscales." As of April 27, 2006, the Convention was in force in 11 countries and three other countries, including Canada, had signed or ratified it but were not yet able to apply it (Canada, Canada Revenue Agency, *Income Tax – Technical News*, No. 34, April 27, 2006, pages 19-20).

[145] The Council of Europe and the OECD have jointly elaborated a *Convention on Mutual Administrative Assistance in Tax Matters* that was opened for signing on January 25, 1988 but that only came into force on April 1, 1995.

[146] See the Preamble to the convention and the explanatory report concerning it.

3.4.3 Solicitor-client privilege

Parliament recognizes the existence of solicitor-client privilege in respect of communications between clients and lawyers.[147] Taxpayers and their legal advisers might invoke the application of professional privilege when faced with requests from the tax administration to file information. The courts must judge whether the information requested by the tax administration concerning aggressive tax planning schemes is protected by solicitor-client privilege. As the case may be, the taxpayers do not have to submit the information to the tax administration.

Solicitor-client privilege can be considered a basic legal right in all legal fields. It seeks, among other things, to enable individuals to exercise their rights, especially in complex fields such as taxation,[148] and facilitate the administration of justice. This privilege will only be lifted if it is necessary to do so to hand down a fair ruling and the benefits stemming from it are greater than the permanent injury that the person entitled to it would sustain.[149] It will only give way to other basic social values or an urgent public interest, e.g. in criminal or public security matters.

In tax matters, the courts have lifted the privilege in the case of tax fraud and criminal or illegal acts. However, aggressive tax planning schemes cannot necessarily be likened to illegal or fraudulent activities. There is therefore a possibility that this privilege applies to communications focusing on aggressive tax planning schemes.[150]

The principles revealed in rulings handed down in civil or criminal cases over the years might affect the application of this privilege in the context of aggressive tax planning schemes. A

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147 Section 232 ITA. Pursuant to this privilege, a person could refuse to disclose an oral or written communication on the grounds that it is a confidential communication between the person and his lawyer.

148 The courts might, in particular, focus more closely on solicitor-client privilege in situations involving multidisciplinary professional relations or complex legal fields such as taxation: see *Minister of National Revenue* v. *Welton Parent*, 2006 FC 67.

149 See *R.* v. *McClure*, [2001] 1 S.C.R. 445, par. 61.

150 See *Fraser Milner Casgrain LLP and Gilbert Schmunk* v. *The Minister of National Revenue*, 2002 B.S.C.C. 1344; *Pitney Bowes of Canada Ltd.* v. *The Queen*, 2003 DTC 5179 (FC).

thorough analysis of these principles goes beyond the framework of this study.[151] We can nonetheless emphasize some of these principles that are of particular interest for the purposes of the study.

Among other things, the courts have recognized that this professional privilege might apply to all communications in the execution of a complex, prolonged mandate.[152] Insofar as the elaboration of an aggressive tax planning scheme can be likened to such a mandate, this recognition might strengthen the application of professional privilege in the realm of aggressive tax planning schemes.

Moreover, the courts have recognized that professional privilege might be lifted in circumstances other than criminal ones, e.g. in the case of abuse or misuse of process in civil matters to achieve an improper purpose.[153] The question that remains is whether the courts might apply such reasoning in the realm of aggressive tax planning schemes.

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151 Developments in the other fields, more specifically in penal or criminal matters, must be considered in their context before they are applied in tax matters.

152 See *Foster Wheeler Power Co.* v. *Société intermunicipale de gestion et d'élimination des déchets (SIGED) inc.*, [2004] 1 S.C.R. 456. Professional privilege is assumed to apply to all communications between the client and his legal adviser in conjunction with a complex mandate whose execution is lengthy. The party that seeks to obtain information must then pose precise, limited questions on the information sought and not engage in a fishing expedition, in order to minimize the undermining of professional privilege.

153 See John Sopinka, Sidney L. Lederman and Alan W. Brant, *The Law of Evidence in Canada*, Butterworths, 1992, pages 736 et seq. (par. 14.57 *et seq.*).

See *Goldman, Sachs & Co.* v. *Sessions*, 2000 B.S.C.C. 157. In that case, the complaining party claimed the payment of a debt that the defendant owed it. The proceeding was dismissed and the defendant claimed damages for abuse of process, alleging that the complaining party had no grounds for initiating proceedings and that it was seeking to force the defendant to conclude a settlement. In light of the defendant's allegations, the court ordered the complaining party to submit the legal opinion to it for examination: "Accordingly, intended crimes and frauds are but instances of the application of the general principle that the privilege does not attach to communications in relation to intended unlawful conduct. In this context, <u>"unlawful conduct" has a broader meaning than simply conduct that is prohibited by the criminal law</u>. It includes breaches of regulatory statutes, breaches of contract, and torts and other breaches of duty. <u>Breaches of contract and of civil duties are "unlawful" because, although they are not prohibited by any enactment, they cause injury to the legal rights of other citizens and give rise to legal remedies. They are therefore contrary to law</u>. It follows, in my opinion, that the professional legal communications obtained to facilitate an <u>abuse of process</u> are not protected by solicitor client privilege. The privilege does not apply because it is no part of a solicitor's professional duties to counsel a client to <u>misuse the court's</u> process for <u>improper purposes</u>." (our underlining)

It should be noted that the courts, in tax matters, have refused to extend the solicitor-client privilege to advisers other than lawyers, in particular accountants. These advisers might have to file with the tax administration information in their possession concerning aggressive tax planning schemes. Consequently, taxpayers and other advisers might be inclined to solicit the participation of legal advisers from the outset in the elaboration of aggressive tax planning schemes.

3.5 Administrative penalties for misleading information provided by taxpayers and third parties

Generally speaking, Parliament stipulates that taxpayers are liable to a penalty when they voluntarily or under circumstances equivalent to gross negligence make a false declaration or an omission in their income tax return.[154]

Briefly, this penalty stands at 50% of the tax under-stated because of the false declaration or the omission. The tax administration must justify the imposition of the penalty before the courts when the taxpayers challenge it.

To our knowledge, this penalty has not been levied in cases involving a difference of interpretation of the law on the application of the anti-avoidance rules.[155] The question that remains is whether the tax administration might contemplate applying this penalty to taxpayers participating in the most aggressive tax planning schemes. If need be, we might also ask whether the taxpayers could defend themselves by alleging the complexity of the law or by relying on the opinion of an adviser.

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[154] Section 163 ITA.

[155] One author reports that CRA representatives have in the past expressed the opinion that this penalty should not apply in cases where the application of the GAAR is uncertain because of different interpretations of the facts and the law that may be valid. See Bruno J. Panteras, "Tax Evasion and the Charter: The Effects and Consequences of Recent Jurisprudence," *Journée d'études fiscales de 1991*, Toronto, Canadian Tax Foundation, pages 11-32.

In this respect, it is noteworthy that the courts have already taken into consideration a taxpayer's lack of expertise in tax matters to lift a penalty.[156] The courts have also already given the benefit of the doubt to taxpayers when they have acted in good faith according to the advice or recommendations of tax advisers.[157]

Third parties may also be subject to penalties if they transmit misleading information in tax matters. This question has already been examined in subsection 2.2.2 a) devoted to tax professionals.

[156] See *Harris* v. *The Queen*, 2005 DTC 1179 (TCC.).

[157] See *Julian* v. *The Queen* (May 11, 2005), No. 2003-2947(IT) I (TCC); *Pilon* v. *The Queen*, 2005 DTC 504 (TCC).

4

Possible solutions

Aggressive tax planning schemes continue to pose a challenge for all stakeholders in Canada. The proliferation of specific rules does not appear to prevent taxpayers and advisers from elaborating new aggressive tax planning schemes that lie outside the field of application of such rules, and that of the GAAR.

We have no choice but to acknowledge the problems posed by the application of the anti-avoidance rules. The crux of these problems is the distinction between legitimate tax planning schemes and tax avoidance arrangements. We must note that these rules do not clearly distinguish between such planning schemes from the standpoint of all stakeholders. The rulings handed down by the Supreme Court of Canada have established the application principles of the anti-avoidance rules to better delineate them but they have not resolved all of the application problems. It should be noted that, according to these principles, doubt concerning tax policy must be interpreted in favour of the taxpayers. Consequently, aggressive tax planning schemes that run counter to fiscal policy might nonetheless dodge the application of the anti-avoidance rules. It should be emphasized that according to the CRA, growth in aggressive tax planning schemes stems from the liberal, indeed permissive, interpretation of Canada's tax laws.[158]

In light of the profile and management of the risks of various stakeholders and the scope of the existing tools, the Canadian tax administration could elaborate additional tools to detect the risks posed by aggressive tax planning schemes.

Several tools could obviously be contemplated, ranging from the modification of certain tax policies to the establishment of other centres of expertise in the realm of tax avoidance. For the

[158] Canada, Canada Customs and Revenue Agency, *CCRA Annual Report to Parliament 2004-2005*, page 18.

purposes of the study, we will dwell on tools that might, at the outset, more clearly define the parameters that delineate legitimate tax planning schemes and tax avoidance arrangements, as well as those tools that allow the tax administration to more quickly identify novel aggressive tax planning schemes.

4.1 Drafting of a preamble that lays out the objects of the law

To dispel doubt over the tax policies pursued, Parliament could draft a preamble that sets out its tax policies in order to better define the purposes of the law. According to the *Interpretation Act*, the preamble of a law is an integral part of it and serves to explain its purpose and scope.[159] A preamble that clearly explains tax policies might contribute to better determining what constitutes an abuse of the law.[160]

4.2 A coherent tax policy

Besides the preamble, the tax rules should be drafted in such a way as to coherently express a tax policy. In this respect, a uniform definition of fiscal concepts might help to dispel doubt over the existence of genuine differences in the purpose of tax policies. By way of illustration, the concept of the cost of an asset might be defined by the amount at-risk of its purchaser for the purposes of the law read as a whole. If need be, a basic concept could be defined differently in a specific rule to carry out a specific fiscal policy, without necessarily compromising the realization of the general policy. Consistent drafting would help to better delineate the purposes of the law.

159 *Interpretation Act*, R.S.C., 1985, c. I-21, s. 13.

160 Pierre-André Côté, *Interprétation des lois*, 3rd edition, Montréal: Thémis, 1999, pages 73-75. Controversy persists not as regards the relevance of the preamble but the weight that it must be given under the circumstances.

4.3 Clarify the scope of the anti-avoidance rules

Furthermore, Parliament could modify the specific rules and the GAAR in order to clarify their scope. These rules could, among other things, stipulate criteria that more objectively delineate to what extent a planning scheme is deemed to be abusive. For example, the law could introduce an economic substance test.

Such criteria might make the taxation system more coherent. They would strike a better balance between predictability in the administration of the laws and the fairness of the taxation system. To this effect, they would help to better delineate the risk area for aggressive tax planning schemes. The distinction between an acceptable tax planning scheme and an abusive one will always involve the exercising of judgment.

4.4 Establishment of a probability threshold

Despite the introduction of the criteria indicated in subsection (c) above, a grey area will usually persist. Therefore, applying such criteria to a planning scheme implies the exercising of judgment. To help taxpayers and advisers, the tax administration could, to this end, establish a probability threshold (reasonable chance of success) that a planning scheme should attain. To fail such a test would mean that an aggressive tax planning scheme risks being likened to an abusive one. Such a threshold could either be provided informally, or be subject to restrictive standards governing taxpayers and their advisers.

For the sake of fairness to all taxpayers, Parliament could compel taxpayers to prove that their aggressive tax planning schemes comply with the law. Self-assessment does not imply the privilege for each taxpayer to define tax policy. It is incumbent upon aggressive taxpayers to fully assume their risks. On the other hand, the tax administration should precisely spell out the tax policy that supports any notice of assessment concerning aggressive tax planning schemes.

4.5 Additional information and solicitor-client privilege

In recent years, the CRA has developed various tools designed to collect information on taxpayers' transactions to ensure that they comply with the Canadian taxation system. The tax administration could request taxpayers, advisers or any other category of persons to file more extensive information concerning aggressive tax planning schemes. Like for tax shelters, it could prescribe the obligation to disclose precise information on targeted aggressive tax planning schemes. The tax administration might find itself in a better position to protect the integrity of the taxation system when circumstances warrant doing so.

However, the accessibility of information in the realm of aggressive tax planning schemes is subordinate to solicitor-client privilege. The tax administration might be unable to consult all of the documents that it deems to be relevant in order to justify the application of anti-avoidance rules. Without the relevant information, it would find it difficult to convince a court that relevant anti-avoidance rules must be applied to an aggressive tax planning scheme.

Depending on the future direction of the jurisprudence in the realm of confidentiality privilege, we may ask ourselves whether the courts might consider that the principles of the taxation system's fairness and integrity can be likened to basic social values or to an urgent public interest and lift the privilege when an aggressive tax planning scheme appears to abusively undermine the taxation system. Here again, the problem fully remains of specifying what is abusive.

4.6 Tax avoidance penalties

Faced with problems relating to the interpretation of a tax policy or access to the relevant information, Parliament could assess the timeliness of levying penalties for tax avoidance to increase the risks for taxpayers and advisers who implement aggressive tax planning schemes.

4.7 Administrative penalties levied on third parties

The establishment of a penalty scheme that is better structured, fairer, and easier to understand would likely reduce the popularity of aggressive tax planning schemes.[161]

In the search for possible solutions, it is relevant to observe the tools that our trading partners have developed in the realm of aggressive tax planning schemes. The experience of these jurisdictions could, in particular, help Canada develop tools that would allow it to reconcile the various objectives of the Canadian taxation system. To this end, we will dwell in the second part of this study on an analysis of certain tools developed in Australia, the United States, the United Kingdom and the European Union to cope with the risks posed by aggressive tax planning schemes.

[161] Frank J. Gould, "Giving Tax Advice – Some Ethical Professional and Legal Considerations," *Tax Notes*, October 2002, page 523.

5

Conclusion

In its *Summary of the Corporate Business Plan 2005-2006 to 2007-2008,* the CRA noted: "No revenue administration has the resources to respond comprehensively to every area of risk. Over the coming decade, our success will be the product of identifying the greatest risks across the full spectrum of our program activities."[162]

Tax avoidance is a problem of national and international scope and there are probably few tax administrations that can boast of escaping it. Its impact on the tax base of governments is considerable. It is therefore reasonable to think that the fight against tax avoidance and tax evasion, while the latter is not covered by this study, will be among the biggest challenges and, consequently, the biggest risks for tax administrations over the next decade.

In this first part of our study on aggressive tax planning schemes and the risks inherent in them, we have attempted to highlight the Canadian situation as regards such planning schemes and, for each of the stakeholders concerned, i.e. taxpayers, tax professionals and the tax administration. We have observed that each stakeholder's risks and motivation in respect of aggressive tax planning schemes differ. On the one hand, taxpayers and tax professionals operate in "action" mode, while the tax administration functions in "reaction" mode as it cannot detect in advance all of the schemes elaborated by taxpayers or their tax advisers (or both). For the tax administration, the guardian of Canadian taxpayers' tax base, the challenge posed by aggressive tax planning schemes is a daunting one.

While the purpose of this study is to ascertain whether it would be to Canada's advantage to profit from the tools developed by certain trading partners, i.e. the United States, the United Kingdom and Australia as well as the European Union, we have sought, above all, in this first

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[162] *Supra*, note 29, page 16.

part of the study, to take stock of the key tools that have been implemented here in Canada by the tax administration to delineate this type of planning scheme and to grasp the context in which they have been established before examining the tools developed elsewhere in this respect and determining the relevance of adapting them here in Canada.

Accordingly, in the second part of this study we will examine the tools that the trading partners that we have selected have developed to contend with the risks posed by aggressive tax planning schemes. We will also examine certain international tools developed in recent years and will assess to what extent Canada could take advantage of them. We will put into context the introduction of these foreign tools, then attempt to evaluate their advantages and drawbacks and determine to what extent it would be relevant and desirable to introduce them in the Canadian context.

The second part of the study will undoubtedly allow us to add new possible solutions to the series already mentioned in section 4 of this first part.

Appendix 1
Overview of certain annual reports of the Auditor General of Canada relevant to this study

Date	Chapter	Observations
1992	Chapter 2 Other Audit Observations	In 1990, Canadian corporations had invested $92 billion ($42 billion in loans and $50 billion in equity) in non-resident companies that they were not dealing with at arms' length and, in 1990, they had received over $4.2 billion in dividends from them. The Auditor General emphasized the importance of tightening up certain tax rules and observed that taxpayers were using them to transfer to Canada losses from offshore subsidiaries and to transfer abroad revenue from Canadian corporations or converting it into exempt income.
May 1996	Chapter 11 Combating Income Tax Avoidance	Although the cost of tax avoidance is unknown, Revenue Canada expected to produce about $365 million in reassessments in 1995-1996 under its anti-avoidance program. The Auditor General noted a growing interest by taxpayers in knowing how to divert income from Canada to an offshore tax haven. Large corporations, especially those effecting numerous domestic and international transactions, often have an opportunity to participate in tax avoidance schemes and they have the resources necessary to do so. Among the schemes, the report emphasized: • weak currency borrowing; • debt instrument issued at a premium; and • debt swaps. The report also emphasized that tax avoidance schemes involving exploration companies in the oil and gas sectors allowed for the transfer of $826 million in losses. Moreover, the report specified that Revenue Canada audited roughly 325 tax shelters over a period of two years and deemed most of them to be abusive. In 1995-1996, the department extended its audits, which led to additional assessments of $161 million. Among the main activities financed through tax shelters were film productions, software development and building construction.
November	Chapter 37	In recent years, financial markets created numerous instruments that

1996	Enforcing the *Income Tax Act* for large corporations	make it possible to take advantage of tax provisions, sometimes in a manner that is at odds with the purposes of the tax law. Governments must also ensure that multinationals pay their fair share of tax relative to the transactions carried out in the country. These firms can plan their affairs to reduce their worldwide tax according to the different types and rates of tax that apply in different countries. Moreover, Revenue Canada auditors are aware of the risks related to transfer pricing but their audit demands a great deal of time and resources, such that the transfer pricing files are not as numerous as hoped for.
December 1998	Chapter 24 International Tax Directorate: Human Resource Management	For 1996-1997, Revenue Canada's international tax programs recovered $630 million. The complexity of the International Tax Directorate's work is apparent in the following sectors: transfer pricing; electronic commerce; non-residents doing business in Canada or disposing of taxable Canadian property; global enterprises and their related-party transactions; tax havens and harmful tax competition; international financing arrangements; and international tax treaties. The International Tax Directorate took a number of initiatives to manage risk to the tax base, in particular strengthening key legislation in transfer pricing, foreign affiliates and disposition of taxable Canadian properties, and exchange of information on transfer pricing and tax havens.
2001	Chapter 7 International Tax Administration: Non-Residents Subject to Canadian Income Tax	The Auditor General noted that the Agency had discovered a number of schemes developed to exploit the *Canada-Barbados Income Tax Agreement*, which schemes were designed to allow a resident of Barbados to claim a Canadian tax exemption on a capital gain that would otherwise be subject to Canadian tax. The CRA identified 53 examples of the offshore spousal trust scheme that had moved over $800 million in capital gains to Barbados from Canada.
December 2002	Chapter 4 Taxing International Transactions of Canadian Residents	The report emphasized that data reported by taxpayers to the Agency indicated that Canadian investments in foreign-related corporations and the value of cross-border trade between companies within the same corporate group had increased significantly in recent years. Between 1996 and 2000, the amount of money that Canadian-resident corporations loaned to, and invested in foreign affiliates increased from $200 billion to over $450 billion. Some data collected in this respect indicated that: • Canada's top 50 corporations have over 1,300 foreign-affiliated corporations, trusts, and partnerships scattered throughout the world;

		• trade in goods and services within these corporate groups was over $250 billion in 2000; • the value of dividends and interest received in Canada from investments in these related entities was over $3 billion; • in the 1990s, foreign trade increased from 50% of gross domestic product to over 80%; • more than 50 percent of Canada's international trade is between related parties. In fiscal year 2000-2001, auditors in the International Tax Directorate of the CRA had completed 1,430 cases and reassessed an additional amount of about $778 million in taxes. Over 350 of these cases involved international transactions made by large corporations that resulted in tax reassessments of over $300 million. Since 1999, the Agency has carried out audits of taxpayers involved in foreign trusts and estimated that there was $400 million in additional income to be reassessed in Canada.
December 2002	Chapter 11 Other Audit Observations	The report emphasized that multinationals can have different reasons for exploiting the interest deductibility rules despite the modifications made. The report also stressed that the changes to the rules governing tax-exempt dividends from foreign affiliates did not resolve the problem of planning schemes that exploited them. The report emphasized that tax havens continue to attract Canadian capital despite the modifications made in 1995. Some of the information presented in this respect: • Statistics Canada reported that Canadian direct investment in Barbados increased from $628 million in 1988 to $23.3 billion in 2001—over a 3,600 percent increase. • Information from the Canada Customs and Revenue Agency showed that in 2000, Canadian corporations received $1.5 billion in dividends from corporations in Barbados, compared with $400 million in 1990. • The CRA identified 3,500 Barbados International Business Corporations, of which 1,700 had Canadian directors. Moreover, the changes made in 1995 to the rules governing taxable dividends from foreign affiliates do not prevent taxpayers from transferring funds to Canada tax-free other than through the payment of dividends. The report emphasizes that the rules governing foreign accrual property income continued to be exploited abusively even after the modifications were made, thus putting tax revenues at risk.

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