Aggressive Tax Planning: How Aggressive is Too Aggressive?

By Jeff Pniowsky

TDS Thompson Dorfman Sweatman LLP

The leaves are falling, the air is turning cool, the kids are going back to school and our summer holidays are quickly becoming mere memories. What better way to shake off those late summer blues than with a pleasant discussion on … aggressive tax planning.

Tax planning is the process of structuring one's affairs in order to defer, reduce or even eliminate the amount of tax payable to the government. We are allowed to arrange our affairs to minimize our income taxes as long as it is done in accordance with the provisions of the Income Tax Act (ITA). The ITA contains provisions intended to limit overly aggressive tax plans and the Canada Revenue Agency (CRA) even has a separate Aggressive Tax Planning Division tasked with ferreting out those plans or business structures that they consider to be off limits. However, these limits are often difficult to discern, leaving taxpayers and their advisors wondering: how aggressive is too aggressive?

As a starting point, our tax legislation inherently invites lawful tax avoidance. While the ITA is first and foremost designed to provide revenue to the Federal Government, over the years it has become much more than a simple taxation code and its complexity is ever increasing. There are two general reasons for this complexity: 1) the ITA is supposed to be a "complete code" - a legislative one-stop-shop that must be applied to an ever changing and complex world filled with creative lawyers and accountants; and 2) the ITA is no longer simply a means to provide the government with revenue, but instead has become an important tool to affect social and economic policy. For instance, saving for one's retirement is recognized as a social good, and so the ITA now allows taxes to be deferred through RRSPs. Small businesses have been described as the engine of employment and the base of our economy, and so the ITA provides specific deductions and exemptions for small businesses. In virtually every area of taxation there is a myriad of specific rules, exceptions and exemptions.

The very reasons for our tax law's complexity also underscore the legitimacy of lawful tax avoidance. Given that the ITA is a complete code, with very specific provisions that both require taxation but also purposefully allow for the exemption of taxation, we must be free to organize our affairs so as to limit or reduce our taxes. Conversely, there can be no obligation on taxpayers to arrange their affairs in a manner that maximizes taxation. The right of taxpayers to minimize their taxes has been reaffirmed numerous times by our courts, including recently by the Supreme Court of Canada in Lipson v. The Queen.

The ways in which taxpayers can lawfully avoid taxes are limited only to tax planners' ingenuity and mastery of the complex web of tax laws. Plans range from a simple application of a tax rule, such as a corporate rollover which allows for a deferral of tax on the transfer of assets, to complex arrangements such as a "surplus strip" which is designed to reduce or even eliminate taxes on withdrawals of corporate earnings. Like all tax plans, their success depends firstly on the proper application of the various tax provisions. However, even if the aggressive tax planner has managed to traverse the ITA to create a technically sound tax savings manoeuvre, the taxpayer is still not out of the woods, since the CRA has a tool of last resort: the General Anti-Avoidance Rule (GAAR).

The GAAR is a legislative balancing act which recognizes the right of taxpayers to lawfully avoid paying taxes, but also guards against plans that defeat the purpose of the provisions being relied on. It should be noted that the vast majority of tax plans are not considered aggressive tax planning of the sort that would invite the use of the GAAR by the CRA. The above described rollover, for instance, could not be considered abusive since the ITA specifically allows for such a deferral.

In order for GAAR to apply, the transactions at issue must 1) result in a tax benefit, 2) be an avoidance transaction - that is, not be arranged primarily for bona fide purposes other than to obtain a tax benefit, and 3) result in a misuse of a provision of the ITA or an abuse of the ITA as a whole. While the taxpayer has the burden of proving the transaction did not result in a tax benefit or was not an avoidance transaction, the CRA has the burden of proving the tax avoidance resulted in a misuse or abuse of the ITA. In many GAAR cases before the courts, the taxpayer readily admits that the transactions were purely tax driven, leaving the burden on the Crown to prove they are abusive.

Establishing a tax avoidance transaction to be abusive is not a simple matter for the Crown. After all, GAAR recognizes that taxpayers can enter arrangements for the sole purpose of avoiding tax. The Crown must go beyond the plain and ordinary meaning of the words of the ITA relied on by the taxpayer and establish what the purpose behind the particular tax rule is and that the purpose is being improperly frustrated.

The recent decision of Lehigh Cement Ltd. v. R., in which the Federal Court of Appeal overturned the application of GAAR, highlights the Crown's difficulty.

In Lehigh, the taxpayer structured its transactions in a novel way that permitted it to use an exemption from withholding tax on interest payable to a non-resident corporation, resulting in the avoidance of millions of dollars in taxes. In finding that the Crown failed to establish that the transaction was abusive, the Court stated as follows:

…the fact that an exemption may be claimed in an unforeseen or novel manner, as may have occurred in this case, does not necessarily mean that the claim is a misuse of the exemption. It follows that the Crown cannot discharge the burden of establishing that a transaction results in the misuse of an exemption merely by asserting that the transaction was not foreseen or that it exploits a previously unnoticed legislative gap. As I read Canada Trustco, the Crown must establish by evidence and reasoned argument that the result of the impugned transaction is inconsistent with the purpose of the exemption, determined on the basis of the textual, contextual and purposive interpretation of the exemption.

However, in other cases the Court has readily agreed with the Crown that the purpose of the provisions being relied on has been violated, resulting in a misuse of the ITA. Given the seemingly subjective nature of what constitutes abusive tax avoidance, some have suggested that the GAAR is in reality a legislative "smell test". Coming close to this suggestion, Justice Boyle, in the case of Collins & Aikman Products Co. v. R. (under appeal to the Federal Court of Appeal) described the reasons why a tax free withdrawal of capital was permitted in the context of the GAAR:

While these may be reasons that the chosen plan worked as tax-effectively as it did, none of these involved the degree of artificiality, boldness, vacuity or audacity to rise to the level of being a loophole or gimmick in common parlance…

In the end, the dividing line between a successful plan that results in significant tax savings and one that results in reassessment by the CRA may very well depend on whether the plan rises to the level of a "gimmick" in the eyes of the particular CRA officer (or judge) scrutinizing the plan. In any event, before engaging in any tax plan, particularly one that promises significant tax savings, it is imperative to consult with a tax advisor familiar with the application of the GAAR, in order to gain a full appreciation of the risks involved.

DISCLAIMER

This article is presented for informational purposes only. The content does not constitute legal advice or solicitation and does not create a solicitor client relationship. The views expressed are solely the authors' and should not be attributed to any other party, including Thompson Dorfman Sweatman LLP (TDS), its affiliate companies or its clients. The authors make no guarantees regarding the accuracy or adequacy of the information contained herein or linked to via this article. The authors are not able to provide free legal advice. If you are seeking advice on specific matters, please contact Don Douglas, CEO & Managing Partner at dgd@tdslaw.com, or 204.934.2466. Please be aware that any unsolicited information sent to the author(s) cannot be considered to be solicitor-client privileged.

While care is taken to ensure the accuracy for the purposes stated, before relying upon these articles, you should seek and be guided by legal advice based on your specific circumstances. We would be pleased to provide you with our assistance on any of the issues raised in these articles.

ABOUT THE AUTHOR

Jeff Pniowsky

Phone: 204.934.2586 | Email: jdp@tdslaw.com | Web: www.tdslaw.com/jdp

Jeff focuses his practice in the areas of tax litigation and dispute resolution in the tax audit and appeals process, tax advisory services, as well as complex commercial litigation. Formerly a senior Tax Litigator with the Federal Department of Justice acting on behalf of the Canada Revenue Agency (CRA) for almost 10 years, Jeff now serves local and national clients with a wealth of experience in litigating at all levels of both the Provincial and Federal courts, including the Supreme Court of Canada.