

Consultation sur les planifications fiscales agressives

Titre du mémoire : Quebec Putting the Screws on Aggressive Tax Planning

Déposé par : Michael N. Kandev

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I. INTRODUCTION

On January 30, 2009, the Quebec government launched consultations on aggressive tax planning ("ATP"). For this purpose, the Minister of Finance issued a detailed discussion paper (the "**Paper**"),³ which describes the problems the government perceives with ATP, examines the legislative tools available to tax authorities to fight against APT and sets out the actions under consideration by the Quebec government to address ATP. This initiative is of significant importance to Quebec taxpayers and their advisors and should also be relevant to taxpayers elsewhere in Canada as this trend is likely to spread.

II. THE CONTEXT OF THE PAPER

Quebec's ATP initiative was first announced in the 2008-2009 Budget. It seems to be motivated by the use in the last twelve years (this is the reference period chosen by the Paper) of various tax plans,⁴ most of which focused on reducing or eliminating provincial taxation and two of which – the Quebec Shuffle⁵ and the Quebec Truffle⁶ – had gained relative popularity before

³ Available at <http://www.finances.gouv.qc.ca/en/page.asp?sectn=2&contn=276>.

⁴ See pages 6-8 of the Paper.

⁵ As described at page 6 of the Paper, the Quebec Shuffle sought to avoid provincial tax resulting from the sale of property, such as shares of an operating company. Prior to the disposition, the seller would transfer the shares of the target corporation to a new corporation established, for example, in Ontario in consideration for shares of the latter. This transfer would be made on a tax-deferred basis in Québec while no rollover election would be made under federal law. Accordingly, no capital gain would be realized under Québec law, but the gain would be triggered for federal tax purposes. For the Ontario corporation, the tax cost of the shares of the target corporation would be equal to the cost of the shares for federal purposes, i.e. a cost equal to their fair market value. Hence, no gain would be triggered for Ontario tax purposes on the ultimate sale of the target shares and therefore provincial tax would be completely avoided.

⁶ The Quebec Truffle sought to avoid provincial tax by placing the residence of a trust in a different province from the one where the beneficiaries reside and by using the flexibility of the system applicable to trusts, which allows for a designation as to which of the trust or the beneficiary assumes the tax relating to income or gains of the trust. There were two main forms of Quebec Truffles: an inbound and an outbound one. The inbound Truffle would see residents of a province other than Quebec establish a trust in Quebec. For Quebec tax purposes a designation would be made that income and gains of the trust would be taxable in the hands of the beneficiaries, i.e. outside of Quebec; while for federal tax purposes, and hence for purposes of the beneficiaries' home province, a designation would be made that income and gains of the trust would be taxable in the hands of the trust, i.e. in Quebec. Therefore, provincial tax would be avoided. Conversely, the outbound Truffle would see residents of Quebec establish a trust in another province. For Quebec tax purposes a designation would be made that income and gains of the trust would be taxable in the hands of the trust, i.e. outside of Quebec; while for federal tax purposes, and hence for purposes of the trust's province of residence, a designation would be made that income and gains of the trust would be taxable in the hands of the beneficiaries, i.e. in Quebec. Again, provincial tax would be avoided.

being blocked by the government. In this context and specifically considering that the main Quebec tax plans are now extinct, the Paper demonstrates the desire of the Quebec government to discourage taxpayers and their advisors from engaging in tax avoidance for the future.

III. THE CONCEPT OF ATP

The Paper uses as its fundamental concept the expression "aggressive tax planning". This is deplorable because ATP is not a term of art: it is not employed by the *Taxation Act* (Quebec) or the *Income Tax Act* (Canada) and is only rarely (and then only colloquially) used in case-law. The nebulous nature of the notion of ATP is obvious from the descriptions provided in the Paper.⁷ First, the government's definition of ATP seems to introduce an unacceptable degree of confusion between two very distinguishable concepts: tax avoidance and tax evasion. In this respect, the Paper begins by correctly⁸ stating that "...a distinction is made between tax avoidance and tax evasion in that, usually, the former does not directly contravene any specific rule of the law while the latter violates at least one statutory provision and, consequently, is illegal." Unfortunately, then the Paper states that ATP covers both tax avoidance and tax evasion. Finally, the Paper clarifies that its focus is only on situations of tax avoidance, but then provides that "the expression [ATP] is to be understood as a generic reference to tax avoidance excluding tax evasion", which deplorably seems to imply that tax evasion is subsumed in tax avoidance.

Second, the scope of the government's definition of ATP seems dangerously broad and confusing as it appears to cover sham situations, abusive tax avoidance plans and non-abusive tax avoidance transactions. In this respect, under heading 1.1 of the Paper, the government first correctly states that "ATP is sometimes described as a tax avoidance transaction that complies with the letter, but abuses the spirit of the law."⁹ Then, as stated above, the Paper defines ATP as "tax avoidance" without qualifying this expression with a reference to abuse or misuse. This,

⁷ At pages 3-4.

⁸ except for the use of the word "usually".

⁹ This first statement seems consistent with the idea that a tax avoidance plan is objectionable only when the GAAR is properly applicable to it. However, query whether the subsequent statement in the Paper that "in general, in terms of income tax, an ATP is said to be a tax avoidance transaction that consists in reducing the effective tax rate of a particular income to a level below the one sought by fiscal policy for such income" is consistent with the GAAR. Arguably not.

¹⁰ See Section 4 and Annex 1 of the Paper.

¹¹ Sections 1079.9-1079.16 of the *Taxation Act* (Quebec).

¹² For example, the failure to file tax returns. See list at page 47 of the Paper.

¹³ This is eloquently demonstrated by the recent 4 to 3 split at the Supreme Court in the GAAR case of *Lipson v. Canada*, 2009 D.T.C. 5015.

¹⁴ 2007 D.T.C. 1230 (TCC).

¹⁵ Calculated on the basis of the 3-month T-Bill average yield plus 4%.
¹⁶ (effective annual of 7.23% and 11.59%)

¹⁷ At 11% late tax interest rate, the individual would need to earn 22.38% and the corporation, 16%.

¹⁸ i.e. mainly the ability to make separate and inconsistent tax elections for Quebec and federal tax purposes.

¹⁹ See Paper, p. 5-8.

²⁰ 500-09-016944-068 (January 30, 2009).

²¹ Quebec's current 11.9% general corporate rate is higher than the 10% abatement, but is lower than all provincial corporate tax rates except those of Alberta (10%) and British Columbia (11%).

²² The Panel does state that several tax plans "took advantage of the autonomous nature of Quebec's tax legislation".

²³ See Finances Québec, *Simplification of the Tax System* (Quebec: Gouvernement du Québec, 2004).

unfortunately, seems to imply that ATP could cover proper non-abusive tax avoidance plans as well. Finally, the government appears to improperly bring economic substance and even sham to the mix by stating that "[except] for the resulting tax benefits, the economic justification of an ATP scheme is generally limited and may even be totally non-existent" and "[ATP] frequently involves circular movements of funds, shell companies..."

IV. THE PAPER'S PROPOSALS

Briefly, the Paper proposes the following specific legislative actions:¹⁰

- The introduction of an early disclosure mechanism applicable to transactions subject to a confidentiality covenant provided by the taxpayer and transactions entitling an advisor to contingent remuneration. Disclosure would be required within 30 days after the transaction begins to be carried out. Failure to make disclosure may result in penalties of up to \$100,000 and the suspension of the limitation period until the time disclosure is made.
- The amendment of the Quebec general anti-avoidance rule ("**GAAR**")¹¹ to expand the notion of avoidance transaction by specifying that the reduction, avoidance or deferral of tax or other amount payable or the increase in a refund under either a Québec law other than the *Taxation Act*, a law of another province of Canada or a federal law are not *bona fide* purposes. The GAAR will not be changed to include an economic substance criterion.
- The extension of the normal reassessment period for application of the GAAR by three years. This longer limitation period would not apply to transactions that have been preventively disclosed to Revenue Quebec within the normal reassessment period and early disclosure transactions.
- The introduction of a 25% taxpayer penalty on the additional tax resulting from the application of the GAAR coupled with a 12.5% promoter penalty on amounts received or receivable by the promoter regarding the ATP. These penalties would not apply where the transactions have been subject to preventive or early disclosure or the taxpayer has shown due diligence.

V. COMMENT ON THE PAPER'S PROPOSALS

The proposals contained in the Paper are a mixed bag, but certain elements should be of particular concern to taxpayers and their advisors.

Regarding the early disclosure proposals, Revenue Quebec is certainly entitled to require and collect information that would allow it to efficiently and effectively administer Quebec's tax laws. Nonetheless the Quebec government should be very careful that such disclosure rules do not impair one of the pillars of a democratic society: solicitor-client confidentiality and privilege.

Regarding the expansion of the scope of Quebec's GAAR to transactions that seek a tax benefit under a law of another province of Canada or a federal law, it is questionable whether this proposal is consistent with Quebec's constitutional jurisdiction to tax. Section 92(1) of the Constitution provides that "[in] each Province the Legislature may exclusively make Laws in

relation to [...] Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes. [emphasis added]" In other words, Quebec may not act as the tax police for and on behalf of the other provinces. It is for each province to protect its own tax base (some have done so). If exchange of information or assistance in collection is required this may be done pursuant to an interprovincial agreement.

Regarding the extension of the normal reassessment period for application of the GAAR, although this proposal may be superficially appealing; practically, it is too broad and should worry taxpayers. Although the extension of the limitation period would be limited only to GAAR assessments, since in theory all transactions are potentially GAAR-able, this proposal could open the door to auditors routinely invoking the GAAR in order to buy time and engage in fishing expeditions. The GAAR could very well become a provision of first resort instead of a tool of last resort thus jeopardizing the predictability, certainty and fairness of Quebec's tax law. Better risk identification and management and a well-trained and well-paid audit force should make such amendment unnecessary.

Regarding the proposed penalty in respect of GAAR-ed transitions, this initiative is disconcerting and completely contrary to the scheme of Quebec's self-assessment tax system. Penalties are levied under the *Taxation Act* only for non-compliance with the letter of the law.¹² By definition, tax avoidance transactions do comply with the letter of the law. Therefore, the concept of penalty is inapplicable. Indeed, whether or not a technically compliant tax avoidance transaction is abusive of the object, purpose and spirit of the law is in the eye of the beholder as Parliamentary intent is rarely clear unless it is embodied in unambiguous statutory wording.¹³ Hence it has been recognized that a GAAR assessment may not give rise to a penalty. In *Copthorne Holdings Ltd. v. Canada*¹⁴ Campbell J. held as follows:

77 It is only because of the application of GAAR that the liability to pay the withholding tax arises. The question therefore is whether the Appellant becomes liable to pay a penalty under subsection 227(8) when it was not technically required to withhold tax under the relevant provisions of the Act. I do not think that a GAAR assessment can give rise to penalties for non-compliance with the technical sections of the Act. First, the GAAR is not a penalty provision. If a transaction, or series of transactions, runs afowl of GAAR, the remedy specified in subsection 245(2) is that tax consequences will be determined that are reasonable in the circumstances in order to deny a tax benefit that would otherwise result from the transaction. Subsection 245(2) does not indicate that a successful GAAR assessment will cure the deficiency in the scheme of the Act but merely that the tax benefit resulting from the technical application of the section will be denied.

78 Second, there is nothing in the GAAR provisions that would allow a taxpayer to self assess on the basis that GAAR applies. [...] I agree with the Appellant's comments and conclude that a successful GAAR assessment prevents the Minister from applying penalties under subsection 227(8), where, according to the technical application of subsection 215(1), there was no tax payable by a non-resident. [emphasis added]

In support of its initiative to introduce GAAR penalties, the Quebec government invokes the need to increase the cost of ATP. Abusive tax avoidance does come at a high cost. The daily-compounding non-deductible interest rate applicable to late tax¹⁵ has fluctuated between 7% and 11%¹⁶ over the last 12 years. Accordingly, a Quebec-resident individual would need to earn 14% before tax and a Quebec-based corporation would need to turn up at least a 10% business return to make the 7% late tax interest worthwhile.¹⁷ This is a pretty steep "borrowing" rate, especially in the current economic environment, and a significant cost for abusive tax avoidance.

In short, the *in terrorem* penalty in respect of GAAR-ed transitions should not be adopted as it would emasculate the *Duke of Westminster* principle, recognized by the Quebec government and the Supreme Court of Canada, that a taxpayer is entitled to arrange his affairs to minimize his tax.

VI. CONCLUSION: THE MISSING BIG PICTURE

The Paper, which is well-written and thoughtful, strikes by the fact that it seems to be missing the big picture.

First, the significant tightening of Quebec's anti-avoidance measures proposed by the Paper is largely unnecessary. The principal statutory weaknesses of the *Taxation Act*,¹⁸ which exposed the Quebec tax base to tax avoidance have now been eliminated.¹⁹ Moreover, the much-anticipated Quebec Court of Appeal decision in *OGT Holdings Ltd. v. MRQ*²⁰ (a case involving a classical form of Quebec Shuffle), which was issued on the same day as the Paper, shows that Quebec's current GAAR is an effective tool against abusive tax avoidance.

Second, the Paper misses the point that since the elimination by the 2007 Budget of Quebec's very high 16.25% rate on passive income, there should be little incentive for corporations established in Quebec to seek access to lower provincial corporate tax rates.²¹

Finally – and this is the elephant in the room – the Panel does not directly acknowledge the fact that Quebec's vulnerability to tax planning has been caused principally by Quebec's insistence on designing and administering a completely autonomous full-blown tax system.²² Indeed, Quebec is Canada's only province with a free-standing individual tax system and, together with Alberta, the only province with an autonomous corporate tax system (Ontario integrated its corporate tax system with the federal one effective 2009). Since avoidance schemes exploit differences between taxing legislations, as long as Quebec resists harmonizing its tax system with the *Income Tax Act*, in theory arbitrage opportunities will always exist. Therefore, the only true and effective solution to Quebec's perceived tax avoidance ails is for Quebec to piggyback the federal tax system like mostly all other Canadian provinces do. Unfortunately, the last time this idea was considered, the report was duly shelved and forgotten.²³