

“The Rule of Law” - a thing of the Past?*

David Louis, J.D., C.A., Tax Partner, Minden Gross

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There has been a growing problem in the Canadian tax system, which, in my view, is now threatening to overshadow all others. A key principle - the rule of law - is falling by the wayside. The rule of law means that a law should be sufficiently specific so as to give citizens fair notice of the consequences of their actions, and so as to provide a legal limit on the discretion of when and to whom a law applies.¹

In the last generation or so, there has been a growing number of tax provisions which have deviated from the rule of law by being either uncertain or overreaching. As a result, I am hearing more and more complaints from colleagues that it is becoming harder and harder to tell their clients exactly what they can and cannot do.

I am not talking about complexity. If income tax provisions were merely complex, as opposed to over-reaching and ambiguous, this would be a major blessing. At least, with a lot of sweat, we could give clients meaningful advice.

However, it seems that every year, there are more and more over-reaching and ambiguous provisions – rules that have an astonishing number of unintended applications. Increasingly, government officials are asking taxpayers to put faith in the premise that the rules will not be enforced in a harsh manner. But in the long run, tax rules become interpreted literally; one cannot depend on paid civil servants to administer the law in an lenient manner.

The Thin Edge

In recent history at least, the problems started with subsection 55(2) – the provision which can turn otherwise tax-free inter-corporate dividends into taxable capital gains. Because of the apparent legislative complexity of the calculation of “safe income” (which “reinstates” dividend treatment), the government got tax practitioners to buy into a set of administrative guidelines relating to this calculation – rules which are often only sketchily outlined in the *Income Tax Act* itself and, at times, the result of the a bureaucratic imagination of how the calculation *should* work, with virtually no legislative support.

The trend continued with the General Anti-Avoidance Rule. Of course, the rule is broadly worded, most notably, indicating that GAAR will not apply unless there is a misuse of the provisions of the Act, or an abuse having regard to the Act as read as a whole.² The uncertain nature of GAAR is obvious. Fortunately, the reasoning in *OSFC*³ is designed to strike a balance between the rule of law and a meaningful application of the provision, indicating that the misuse or abuse must be clear and unambiguous from a

policy standpoint before GAAR can be applied. Even with this critical judicial protection, GAAR is still becoming a regime unto itself. For example, it is an abuse to move losses between unrelated corporations,⁴ e.g., in the form of deductions, yet the same might not be said for moving profits.⁵ But how apparent would this have been prior to the relevant cases?

The trend continued with the so-called “civil penalties”.⁶ My feeling is that these provisions contain a standard basically equivalent to so called “gross negligence”, per subsection 163(2).⁷ Happily it looks like they will be enforced only for truly “egregious” conduct – for a while. But I believe that, ultimately, they will go the way of directors’ liability for withholding, a provision which was also promised to be used only in extreme circumstances. So professionals should continue to be concerned about the prospect of less selective enforcement – a scenario which has the potential to destroy the livelihood of an unlucky professional.

There are many other overreaching provisions. For example, taken literally, a “dividend rental arrangement” may include a safe income strip. Just a few years ago, landmark Supreme Court of Canada cases generally validated one-shot deductions for tenant inducement payments by landlords. However, another provision which, at first blush, seems to have little to do with this area, can be interpreted as requiring these payments to be amortized in many situations.⁸

Going over the top

But one of the most outrageous violations of the rule of law to date occurred only weeks ago, when the government released proposed section 3.1 of the Act – a statutory “reasonable expectation of profit” test. The proposal, to be applicable starting in 2005, indicates that, in order to claim a tax loss for any particular year, it must at that time be reasonable to expect that the taxpayer will realize “cumulative profits” from the business or investment during the time that he or she can reasonably be expected to carry on the particular business, or hold the investment.⁹ Taken literally – as of course, it should be – the measure means that investors in public company common shares would almost never be able to demonstrate that they have met the reasonable expectation of profit test – because it is almost unheard of to hold shares for a period sufficient for cumulative dividends to exceed associated interest charges. Virtually simultaneously, the CRA released Interpretation Bulletin IT-533 relating to interest deductibility, which reaffirmed the government’s pre-existing administrative policy in this area. Amazingly, the government’s press release indicates that the proposal will “reaffirm” many current practices that support the deductibility of interest, “including those relating to the deductibility of interest on money borrowed to purchase common shares”.

For the reasons above, this is simply not supported by the legislation: the apparent explanation may be contained a letter to the Minister of Finance by the Investment Funds Institute of Canada, indicating that finance officials have stated that they do not intend

the CRA to **administer** the law as proposed. Clearly, such administration would be contrary to the wording of the proposed provisions.

The letter indicates that this arrangement is “clearly unacceptable and likely unworkable under our legal system.” What I find most “unacceptable” is that the government itself is advocating the demise of the rule of law and instead is asking taxpayers to trust in the administrative largesse of the CRA.

No, I don’t trust them. In fact, I am *offended* by a government that is so willing abandon the rule of law. The scenario that such provisions invite is one where practitioners pour over CRA missives *as if* they were the actual law. When this applies, practically speaking, it gives the CRA wide-ranging powers to create its own laws. In plain words, under such a regime, there is no rule of law; instead, taxpayers are governed by the edict of paid civil servants.

The reinstatement of the rule of law should be a very high priority. Personally, I would like to see overreaching and uncertain tax rules redrafted. I think we would find that, when they are tallied up, we would have nothing less than an overhaul of substantial portions of the Act. But in any event, the trend away from the rule of law should be resisted by all professionals and their representative bodies.

¹GAAR - What We May Expect, W.J.C. Mitchell, 2000 PPC p.2:4,

² Other than GAAR itself.

³ *OSFC Holdings Ltd. v. The Queen*, 2001 DTC 5471, Federal Court of Appeal.

⁴ Per *OSFC* itself.

⁵ *Loyens v. The Queen*, 2003 DTC 355, Tax Court of Canada.

⁶ Per section 163.2 of the Act.

⁷ Not all commentators agree with this.

⁸ The provision was not in effect when the fact situations in *Canderel* and *Toronto College Park* arose, and was therefore irrelevant to these cases. See CRA Doc. No. 1999-0011755 (February 15, 2000).

⁹ Another provision makes it clear that, in determining the “profit”, capital gains don’t count.