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10 Years After – Tax in the New Millennium

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When tax practitioners look back to the beginning of the decade, many may think of the tax environment that existed back then to be a halcyon time – relatively, at least. Is this selective memory? A couple of cases in point: at the beginning of the decade there had been a few GAAR cases, but none had gone beyond the bottom tax court, so that their practical impact was limited. Although the non-resident trust and foreign investment entity rules had been proposed in the 1999 Federal budget, the bewildering complexity and pointlessness of the proposals had yet to become evident.**[1]**

So where have we gone for the last 10 years? Presented below are what I consider to be the tax highlights of the last decade.

- **February 2000 budget – lower corporate tax rates.** The first federal budget in the New Millenium contained the best news in my list of tax changes. It ushered in an era of dropping corporate tax rates, especially for full-rate business income. Taking post-2000 budget proposals into account, the federal corporate tax rate on business income is to be cut nearly in half in a dozen years or so, dropping from 28%**[2]** before the 2000 federal budget to 15% by 2012. (After this, the world ends?) The target federal/provincial corporate tax rate for full-rate business income**[3]** is 25%. For wealthier clients, this may change the decision of whether to bonus down to the small business limit, not to mention structuring an investment business so the company has more than five full time employees (if possible). But I am always amazed about how many taxpayers haven't seen the light.

- **December 2002 – the end.** Draft technical legislation is released. This is the last time a comprehensive package of technical amendments was tabled. Changes have yet to come into effect, perhaps because the technical proposals were "bundled" with policy changes, notably the unpopular and controversial non-resident trust and FIE rules in former Bill C-10**[4]**. The Bill was eventually torpedoed in the Senate (of all places) in the summer of 2008.

- **Fall 2003 – releases and more releases.** The era of legislation by press release goes into full swing. In October, the Department of Finance issued a press release**[5]** announcing a clampdown on tax-free payments for non-competition and other "restrictive covenants". The legislation turns out to be "ugly" - ending up in the Bill C-10 black hole.

  Later that month, another press release**[6]** is issued with proposals to respond to court cases**[7]** in which the "reasonable expectation of profit" test was rejected as a general test for determining whether a taxpayer has a source of income.**[8]** The proposals appear to have vanished and Interpretation Bulletin IT-533 is the guidepost to interest deductibility.

  In December of 2003, another press release clamping down on buy-low/sell-high donation schemes is issued by the Department of Finance**[9]**.

  None of these initiatives have become law.

- **October 2005 – GAAR and the top court.** The first GAAR cases to reach the Supreme Court, Canada Trustco and Kaulius, are released.**[10]** Tax practitioners complain about resulting uncertainty. Would things get better? Read on.

- **November 2005 – income trusts and eligible dividends.** The Liberal government announces the "eligible dividend" regime to stem the tide of income trust conversions**[11]**. It didn't work out too well: a year later, the Conservative government breaks its promise and taxes publicly-traded income trusts and partnerships**[12]** - in the light of the then-proposed conversions by BCE and Telus. Two years later, the government changes the taxation of eligible dividends so that, by 2012, the federal tax benefits will be all but eliminated.

- **2006-2007 - Tax Shelters "R" US.** A string of cases on "tax shelters" go against taxpayers.**[13]** Among other things, the cases trash conventional King and Bay wisdom that tax shelter status will not apply based on the "no rep" argument – e.g., that representations as to deductions and the like (a requirement for tax shelter status) must be "legal" representations. Per the Baxter case, representations need only to be "communicated" or "announced" (presumably, including verbally) to "prospective purchasers" — and not necessarily to the particular taxpayer**[14]**. RIP to the syndicated tax deal (they were actually dead already).

- **April 2007 – full reverse, Scotty.** The 2007 Federal Budget includes proposals that would do nothing less than disallow interest deductions in respect of investments in foreign affiliates in the vast majority of situations. The Department of Finance later restricts the rules to "double dip" situations, and then abandons them completely in the light of criticism from the Advisory Panel on International Taxation.

- **2008 – Return of the Jedi**. After a generation of acceptance of Draconian tax legislation, an ad hoc group of senior tax practitioners protest some of the controversial tax proposals in Bill C-10, particularly the non-resident trust, FIE and restrictive covenant proposals. Representatives appear before the Standing Senate Committee on Banking, Trade and Commerce. The normally docile Senate effectively torpedoes Bill C-10, which died with the call for the 2008 election.

- **December 2008 – The View.** The final report of the "Advisory Panel on Canada's System of International Taxation" is released. In a refreshing change from recent tax policy initiatives, its recommendations generally call for a loosening of the international tax rules. To give but one example, the Report recommends exempting capital gains by Canadian shareholders on foreign affiliate shares which derive substantially all of their value from active-business assets.**[15]**

- **January 2009 – GAAR redux.** The Supreme Court of Canada releases the Lipson **[16]** case, which was appealed to the top court in an effort to bring some certainty to the application of GAAR. The effort backfired – badly – with the Supreme Court decreeing, among other things, that it's GAARable to use an anti-avoidance rule to your advantage. What with several different judgments being delivered, the application of GAAR is even less certain than before**[17]**.

- **October 2009 – aggressive tax planning.** The Quebec Ministry of Finance releases "Fighting Aggressive Tax Planning".**[18]** The measures proposed in this Bulletin may result in serious penalties, as well as new reporting obligations. Among other things, taxpayers who are reassessed under GAAR will be subject to a penalty of 25% of the additional tax, with the "promoter" of an avoidance transaction subject to a penalty of 12½% of the amounts received, unless early disclosure rules have been complied with.

In summary, while there have been a few developments which are favourable to tax practitioners and their clients, most have been adverse, with much of the difficulty relating to the uncertainty as to the status of tax legislation. Let's come back to our cases in point at the beginning of the article. At the beginning of the decade, the application of GAAR was uncertain. It's still uncertain, although it's likely to apply to more situations than many would have envisioned a decade ago. Ten years ago, the non-resident trust and FIE rules were up in the air; a decade later, even more so. The legislation is on its seventh round; how much of it, if any, will become law is a matter of speculation.

The first priority of the Department of Finance should be to try to clean up the mess. While the enactment of technical legislation is out of its hands, it should make clear to the legislators that this clean-up should have priority. Besides the passage of legislation, many of the proposals themselves have to be cleaned-up, particularly in the international area. In an era where it is commonplace to engage in international operations, the foreign affiliate rules should be sufficiently simple that it is not necessary to consult an international specialist every time a client does a transaction. To become up to speed, practitioners are forced to sift through "comfort letters".**[19]**

Enough already. Can we fix this, before the tax rules become a shambles?

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[1] The draft legislation, which was released on June 22, 2000, was described in an early article as "Byzantine" (See "Foreign Investment Entities" Allan R. Lanthier, 2000 CTH 8(7) p.49).

[2] Counting corporate surtax, the federal rate was 29.12%.

[3] I.e., not eligible for the small business deduction.

[4]The convolutions of the FIE proposals are illustrated by the following passage from the 1999 federal budget, pertaining to the pre-existing provision:

Revenue Canada has had difficulty in enforcing this provision because of the frequent lack of information and the challenge of establishing that the interest in the foreign-based investment fund was acquired primarily to avoid Canadian tax. . . . When the provision has been applied, it has been criticized as subjecting to tax an arbitrary amount that may bear no relationship to the actual income accruing in the fund.

Of course, the proposals now include a tax avoidance motive test for a number of common foreign investments, and the primary determination of the taxable amount under the proposals is based on an arbitrary amount. The CRA's ability to obtain information has greatly increased over the decade. Do we really need to overhaul the legislation?

[5] Department of Finance News Release No. 2003-049; October 7, 2003.

[6] Department of Finance News Release No. 2003-055, October 31, 2003.

[7] *Stewart*, 2002 DTC 6969 (SCC); *Walls*, 2002 DTC 6960 (SCC).

[8] And in which "income" in the context of paragraph 20(1)(c) was interpreted to mean gross income; see *Ludco*, 2001 DTC 5501 (SCC).

[9] Department of Finance news release No. 2003-061, December 5, 2003. These schemes are still being litigated; see *Russell* v. *The Queen,* 2009 TCC 548.

[10]*The Queen* v. *Canada Trustco Mortgage Company*, 2005 DTC 5523, and *Mathew* v. *The Queen* (sub nom. *Kaulius* v. *The Queen*), 2005 DTC 5538, respectively.

[11] Department of Finance News Release 2005-082, November 23, 2005.

[12] Department of Finance News Release No. 2006-061, October 31, 2006

[13] Including *Maege*, 2006 DTC 3193, TCC, affirmed, 2008 DTC 6263, FCA; *Tolhoek* 2007 DTC 247, TCC, affirmed 2008 DTC 6279, FCA; and *Baxter,* 2007 DTC 5199, FCA, reversing 2006 DTC 2642, TCC.

[14] For further discussion, see "Heavy Case Load" by the author; *Tax Notes* No. 534, July 2007.

[15] See paragraph 4.52 of the Report. As for the fact that it may seem inconsistent to exempt gains on the sale of foreign affiliate shares while taxing gains on the sale of Canadian company shares, the Report reasons that "this difference can be accepted on the basis that the current rules are out of step with most other countries that have exemption systems," and would also result in a simpler tax system (see paragraph 4.53).

[16] 2009 DTC 5015.

[17] While *Lipson* has been cited as providing support for tax planning to maximize interest deductibility, practitioners are troubled by the lack of analysis in determining the purpose of the attribution rules that the majority of the court held were abused. This makes more confusing the standard for finding abuse based upon violation of a statutory scheme.

[18] Information Bulletin 2009-5, October 15, 2009.

[19] Many Interpretation Bulletins are badly out of date, with no warning to readers.