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December 16, 2011

Tax Policy Branch – Court Caseload Consultation
Department of Finance
140 O'Connor Street
Ottawa, Ontario
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Dear Sirs/Mesdames:

Re: Proposals to Improve the Caseload Management of the Tax Court of Canada

On behalf of PricewaterhouseCoopers LLP, I am pleased to provide comments in response to the proposals to improve the caseload management of the Tax Court of Canada ("Tax Court") announced in a Backgrounder on November 11, 2011. In that Backgrounder, the Department of Finance invited interested parties to comment on the proposals.

We agree that the backlog in the Tax Court is a significant concern. In our view, a fair and accessible appeal process is a fundamental part of maintaining the legitimacy of a tax system in the eyes of those subject to it. Thus we applaud the Government's efforts in this regard, although we outline below our concerns with respect to one of the proposals.

However, we urge the government to not stop at procedural reforms at the Tax Court. In our view, the government needs as well to address the underlying factors that have led to this backlog. In particular, it is our view that the number of taxpayers who, as a result of positions taken by the Canada Revenue Agency (the "CRA"), feel compelled to seek redress in the Tax Court is unnecessarily high. Unless the number of appeals can be addressed, we are concerned that any reforms to the Tax Court administration itself will ultimately be futile. To this point, we outline below what we consider the major reasons for these appeals and suggest possible solutions to deal with them.

Tax Court Reform

The Backgrounder identifies three areas in respect of which reforms are proposed. The first two proposals involve increasing the monetary limits for appeals to qualify for the informal procedure and allowing for "pro-tanto" appeal to be heard, respectively. The third proposed reform concerns the hearing of "common questions". We address our concerns with this third proposed reform below.

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Common Questions

It is proposed that the *Income Tax Act* (the "ITA") be amended to permit the Tax Court, on application by the Minister of National Revenue, to hear a question arising out of identical or substantially similar transactions and cause the resulting judicial determination to be binding across a group. Only a taxpayer who has already filed an appeal in the Tax Court would be allowed as of right to appeal the decision; other taxpayers in the named group affected by the determination would only have the right to appeal if granted leave to do so by the Federal Court of Appeal.

The Backgrounder does not provide any real guidance as to what is considered to constitute an "identical or substantially similar transaction" and what is considered to be a "group". It is prima facie a fundamental right of the taxpayer to have his or her own case heard and to be represented by counsel of his or her own choice, a right specifically recognized in subsection 17.1(1) of the *Tax Court of Canada Act*. In our view, it is critical that there be transparency about the criteria that will be applied in determining what constitutes a "substantially similar transaction" so that the situations in which this rule is invoked are limited to those cases in which this is the only effective means of dealing with a number of cases. In other words, there needs to be clarity on the circumstances in which the facts could be so similar as to render it fair and reasonable to deal with the substantive issue only once. In our experience, outside of the tax shelter context (in respect of which a common question provision is likely not necessary given the specific rules in the ITA concerning such arrangements), situations where fact patterns would be similar enough to warrant grouping together are uncommon.

In addition, we also urge that certain situations or issues be exempted altogether from the application of the proposed amendments, specifically:

1. A "large corporation" that has filed a notice of objection under subsection 165(1.11) of the ITA. The process for preparing and filing a notice of objection under this subsection involves significant effort by the taxpayer to choose an advocate and work with that advocate to prepare arguments that support the taxpayer's position. A taxpayer, having undergone such efforts, should be entitled to rely on those efforts and that advocate to present its case.

2. Issues involving the application of the general anti-avoidance rules ("GAAR"). Any determination regarding the application of these rules is, by the nature of the provision, heavily dependent on the specific facts of a transaction. As well, with respect to any GAAR assessment, taxpayers should be entitled to be represented and make arguments in consultation with, their own representative. An exception could be made to have the rule apply to cases involving GAAR issues where there is evidence of some sort of "plan" that was marketed to large groups of persons whose situations cannot be differentiated on their facts.

3. Issues involving the application of a tax treaty. Again, many determinations that involve the application of a treaty are heavily fact dependent. Those that involve treaty interpretation usually involve difficult questions and we have the same concern voiced above that a taxpayer should be entitled to be represented by counsel of choice.

The Backgrounder also describes the process by which a taxpayer named in an application can appeal a determination of the substantive question. It states that a taxpayer (or the Crown) may appeal a determination made by the Tax Court to the Federal Court of Appeal (although only upon leave being granted in the case of taxpayers who had not yet appealed to the Tax Court). However, no mention is made of a taxpayer's ability to challenge the application in the Tax Court in the first place, as is permitted in respect of a section 174 application. We are hopeful that this is just an oversight in the drafting of the Backgrounder, and that the same rights to make representation at the Tax Court level in respect of a section 174 application will be included in the proposed amendments.

As a final point we would caution that, before implementing this amendment, the government should carefully assess the possible benefits to be gained from this initiative. The expected decrease in cases being appealed to the Tax Court as a result of the proposed amendments must be measured against the additional potential burden on the Courts arising from challenges to grouping applications and inevitable subsequent appeals of groupings and of determinations to the Federal Court of Appeal.

Canada Revenue Agency - Changes that Could Make a Difference

In the final report of Finance Minister Jim Flaherty's Advisory Panel on Canada's System of International Taxation, issued in December 2008, the Panel noted that during its consultations it "heard negative comments from various perspectives regarding the relationship between business and the CRA" and warned that "[f]urther deterioration in the relationship could jeopardize the ongoing viability of Canada's self-assessment system, resulting in higher compliance and administration costs as well as more potential for dispute and litigation. The Panel recommended that the government take steps to enhance the "dialogue among taxpayers, tax advisors and the Canada Revenue Agency to promote the mutual responsibility and cooperation required to uphold Canada's self-assessment system."

We believe one of the key reasons cases unnecessarily end up on the Tax Court docket is an inability to resolve more tax disputes between the taxpayer and the CRA at the audit stage. This is the consequence of the "deterioration" in the relationship between taxpayers and the CRA that the Panel forewarned. In our view, resolving more tax disputes at the audit stage is the most cost-effective way of managing these issues and is the real solution to ending the backlog and preventing a further accumulation of appeals to the Tax Court.

We believe, as the Panel advised, that the government needs to take more direct action and work more closely with taxpayers and tax advisors to improve the current relationship

between taxpayers and the CRA.

We highlight below several areas where we believe there are problems and suggest possible solutions.

1. Audit Process

Overview

In recent years, senior CRA officials have spoken about establishing an "enhanced relationship" with taxpayers. This initiative is also going on within other major OECD countries, in particular, in the UK, Australia and the US. Among other things, the "enhanced relationship" envisions a more open and transparent dialogue between taxpayers and the CRA.

The audit process – how it is managed by the CRA and responded to by taxpayers – sets the tone for the relationship between taxpayers and the CRA.

We believe that most taxpayers fully respect the audit process and recognize the CRA rights under the ITA to obtain information from taxpayers. They realize that the CRA expects them to be open and transparent but in turn they expect that the CRA will behave in a manner that is respectful of taxpayers' rights under the ITA and as articulated in the *Taxpayer' Bill of Rights.*

In June 2010, the CRA released its policy in regards to acquiring information from taxpayers, registrants and third parties. The policy is intended to provide direction and guidance to ensure national awareness and consistency in the process of acquiring information from taxpayers. The policy states that officials' use of compliance tools "will be guided by the CRA's belief that tax administrations can achieve more effective and efficient relationships with taxpayers and their intermediaries by basing CRA actions on an understanding of the taxpayer's business, impartiality, proportionality, openness and responsiveness."

It also states that "officials will always attempt to collect information from the most direct source in the least intrusive manner possible." In this regard, CRA audit officials are to consider five principles when evaluating the need to request information: legislative authority, intent, relevance, transparency and impartiality.

The policy document goes on to state that:

> *"Officials will clearly communicate their intent to the taxpayer or registrant when requesting information for the purpose of activities such as audit or collections."*

And, further:

> *"Officials will clearly identify the transaction, claim or issue they are reviewing as early as possible to the person whose affairs are under review. This will provide transparency to the process and enable the timely production of relevant information and documents."*

With respect to resolving disputes, the policy document provides that

> *"Taxpayers and their representatives are encouraged to discuss material differences of opinion regarding the relevancy of information being requested with the official requesting that information. Where taxpayers or representatives continue to have concerns, they are encouraged to raise the issue with that official's supervisor, and to move progressively to higher levels of management as appropriate."*

Issue

In our view, the internal accountability level for CRA auditors in accordance with the above policies and procedures has not been sufficient. Many taxpayers complain of unreasonable requests for information from and unreasonable positions being taken by CRA auditors without sufficient input from taxpayers. As important, the failure of the CRA to adhere to these policies and procedures mean that they are not conducting an audit in the open and transparent manner that is expected by taxpayers. This serves only to increase tension in the relationship, leads to more disputes and forces taxpayers to appeal assessments at significant cost.

Suggested solutions

We believe the above policies and procedures, if adhered to in a more consistent manner nationally, would go a long way to enhancing the relationship between taxpayers and the CRA and would help resolve disputes at the audit level. The CRA should be urged to increase the awareness and enforcement of these policies and procedures throughout the agency.

We understand that the CRA recently announced that they will be rejuvenating "Audit Review" such that an independent audit team will be responsible for the review of proposed audit reassessments files before they are actually reassessed. We applaud this measure and encourage the CRA to implement it as soon as possible.

Issue

Increasingly, it appears that when there is disagreement between the taxpayer and the CRA auditor on technical issues, there is a reluctance on the part of the CRA auditors to refer the issue to CRA headquarters for input. Instead, all too often the outcome is that the taxpayer is reassessed before it has time to escalate the matter.

Suggested solutions

There should be a greater willingness to refer issues to CRA Headquarters, in particular, to the Income Tax Rulings Directorate, which is described in Information Circular 70-6R5 as being the centre of income tax expertise within the CRA. Where such a referral is not made, there is a much greater likelihood that the cases end up in Appeals and, ultimately in Tax Court. Alternatively, if a taxpayer knows in advance that an auditor's position is supported by CRA Headquarters, there is a much greater chance that a notice of objection will not be filed or that a resolution might be reached.

In this regard, the funding of Rulings Directorate in Ottawa should be reviewed with a view to expanding and strengthening its experience and expertise.

Issue

Many cases cannot be settled at the audit stage as the result of the limited scope the CRA has to enter into a settlement, based on the CRA's interpretation of subsection 220(1) of the ITA.

Suggested solutions

In our view, either a change in law or policy is needed to encourage auditors to offer reasonable settlements. To this end, guidelines would have to be prepared. The specific issues that the CRA is permitted to settle could be identified as well as the parameters of possible settlement positions. A special team at CRA Headquarters could be created to review any proposed settlement to ensure that it is acceptable. In addition, where a settlement is reached, a taxpayer could be warned that if the same type of transaction occurs again, there will be penalties applied to encourage future compliance.

2. SR&ED Claims

Issue

Currently the CRA's mechanism to resolve disputes that arise between taxpayers and CRA's Research and Technology Advisors (RTA) with regard to scientific research and experimental development (SR&ED) claims is not working. While disputes on financial issues rarely arise, disputes over technical issues are common. In the last three to four years there has been a reluctance across the country on the part of Assistant Directors of SR&ED (who typically will not have any scientific or technological knowledge themselves) to allow requests for administrative second reviews of a claim. To obtain recourse, taxpayers must appeal the denied claim to Appeals, which concentrates on whether the taxpayer received "due process" and not on the technical merits of the claim. As a last resort, the taxpayer is forced to appeal to the Tax Court.

Suggested solution

In the 2008 Federal Budget Plan, the government committed to addressing administrative challenges in the areas of predictability and consistency with respect to the SR&ED Program. One of the administrative measures indentified included, "Reviewing dispute resolution procedures to ensure their effectiveness". The CRA must follow through on this commitment, ensuring that sufficient technical review is available before the official appeal stage. At present, this is not occurring.

3. *Valuation*

Issue

In our experience, cases that only involve valuation issues are increasingly going to the Tax Court. These cases do not represent an efficient use of the Tax Court's time, as they do not involve an interpretation of the ITA, and instead require Justices of the Tax Court to listen to expert witnesses to come to a determination.

Suggested solution

Unless the valuation issue is part of a series of transactions that will affect other results (i.e. leveraged donation arrangements and other tax shelters) it should be capable of being settled by an independent arbitrator at the audit stage.

4. *Appeals Process*

Issue

In our view, there are a number of issues that are inappropriately being referred to the Tax Court by CRA Appeals officers because it was not possible to reach a reasonable resolution of this matter with Appeals.

Suggested solutions

CRA Appeals officers should be more selective about what issues should be tried in the Tax Court. For instance, the Appeals Branch could consult with the Compliance Programs Branch before taking certain issues to the Tax Court. There should also be some mechanism to ensure that there is consistency in the CRA's assessing practices and in the determinations made by the CRA Appeals across the country as to what cases to take forward.

In addition, we would suggest that a new level of appeal be introduced before a case is referred to the Tax Court. This appeal could be examined by a panel similar to the Board of Referees used in Unemployment Insurance appeals. The panel could consist of retired

judges and tax practitioners set up as teams across the country to review cases based on issue or dollar amounts.

5. Advanced Pricing Arrangements

Issue

The Advance Pricing Arrangement ("APA") program is a proactive service offered by the CRA to assist taxpayers in resolving transfer pricing disputes that may arise in future taxation years. Considering that transfer pricing issues can be very complex, factually based tax disputes to resolve, the APA program has been very popular within multinational companies to manage their tax risks and potentially avoid very lengthy transfer pricing audits, which can result in major tax reassessments. Transfer pricing reassessments by the CRA are becoming more significant and are generally very time consuming for the Tax Court to deal with as exemplified by the recent *GSK* and *GE Capital* decisions.

Irrespective of the significant increase in popularity of the APA program, the CRA for a number a number of reasons (e.g., lack of resources) appears to be taking actions to limit access to this popular program by rejecting APA applications due to the complexity of the transfer pricing issues. This is very detrimental to the program, as these concerns relate to the main reason taxpayers consider using the program, i.e., to obtain certainty with respect to complex intercompany transactions. The probability is very high that it will be these very complex transfer pricing issues that will eventually need to be addressed by the Tax Court.

Suggested solution

We are of the view that significant potential pressure on the Tax Court can be prevented if the CRA took steps to increase accessibility to the APA program by taxpayers instead of limiting it.

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We appreciate having the opportunity to submit our recommendations. We would welcome any opportunity to discuss them in greater detail with you.

Yours truly,

Nick Pantaleo, FCA
Canadian National Tax Services

cc: The Honourable James Flaherty, Minister of Finance
The Honourable Gail Shea, Minister of National Revenue
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