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Policy Forum: Responses to Aggressive Tax Planning—A Study Framework

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ABSTRACT

In this short article, the authors describe a study framework for analyzing tools developed by selected tax administrations in response to aggressive tax planning. The ultimate objective of the study is to assess the potential benefits of adopting such tools to complement Canada's general anti-avoidance rule.

KEYWORDS: ANTI-AVOIDANCE RULES ■ TAX PLANNING ■ DISCLOSURE ■ GAAR ■ SUPREME COURT DECISIONS ■ TAX POLICY

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INTRODUCTION

Canada and a number of its trading partners—notably, Australia, the United States, and the United Kingdom—are seeking more effective ways to increase revenues by reducing the "tax gap," and the resulting loss of tax revenues. Briefly defined, the tax gap is the difference between the amount of tax that taxpayers should pay under the tax laws and the amount that they actually report and pay. As described by the US Government Accountability Office,

> [t]he tax gap is an estimate of the difference between the taxes . . . that should have been paid voluntarily and on time and what was actually paid for a specific year. The estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or on time.[1]

Many factors contribute to the tax gap, including innovative planning by taxpayers to minimize their tax payable. Taxpayers can quite legitimately organize their affairs so as to minimize their tax payable within the limits allowed by law. However, some taxpayers may seek to take advantage of the tax rules and claim tax benefits beyond those limits. In such cases, taxpayers are carrying out what some tax administrations consider to be aggressive avoidance transactions—arrangements that cause the state to lose revenue and damage the integrity of the tax system.

OUTLINE OF THE STUDY

In 2005, the Research Chair in Taxation and Public Finance at l'Université de Sherbrooke (herein referred to as "the research chair") initiated a study on aggressive tax planning, in light of concerns expressed by the principal stakeholders—tax administrations,[2] the courts, taxpayers, and tax advisers. The purpose of this ongoing study is to encourage thinking and discussion among these stakeholders in Canada by taking a comprehensive and pragmatic approach to various issues inherent in aggressive tax planning.

More specifically, the study focuses on tools developed by Canada and some of its major trading partners in response to aggressive tax planning implemented by taxpayers and tax advisers. We have opted to analyze some of the most important tools developed by Australia, the United Kingdom, the United States, and the European Union. Our ultimate goal is to assess whether it would be worthwhile for Canada to

1 United States, Government Accountability Office, *Tax Compliance: Multiple Approaches Are Needed To Reduce the Tax Gap*, GAO-07-391T, testimony before the United States Senate Committee on the Budget, January 23, 2007 (Washington, DC: GAO, 2007), 3-4.

2 For simplicity, we use the expression "tax administration" in the broad sense to refer generally to the legislative, executive, and administrative powers of a taxing jurisdiction.

adopt one or more of these tools (or modified versions thereof) in order to better safeguard its tax system.

The study framework described in this article lays out the parameters for a comprehensive analysis of the anti-avoidance issues and the tools applied in the four jurisdictions. The assessment was carried out taking into consideration the point of view of each stakeholder group in relation to generally recognized principles of tax administration. In subsequent articles, we will discuss each of the tools in detail and set out what we believe is a balanced approach based on sound practices in other jurisdictions—that is, practices that integrate policy and regulations, and are endorsed by most stakeholders.

As the Supreme Court of Canada mentioned in the *Canada Trustco* case, the line between legitimate tax reduction and abusive tax avoidance is by no means clearcut.[3] A range of qualifiers is used in the literature to indicate the diversity of planning in this grey zone of tax avoidance, including, for example, "sophisticated," "abusive," "creative," "aggressive," and "unacceptable." For the purposes of our study, we chose the term "aggressive tax planning" to capture the idea of risk management for all stakeholders.

AGGRESSIVE TAX PLANNING: STAKEHOLDERS' CONCERNS

Canadian Context

In 2005, the Canada Revenue Agency (CRA) announced its intention to strengthen its focus on aggressive tax planning. It defined such tax planning as follows:

> In Canada, it involves transactions, arrangements or events that are normally fully disclosed but undertaken to achieve a tax result that is not supportable within specific anti-avoidance provisions or the overall scheme of the Income Tax Act, Excise Tax Act, or Income Tax Conventions. Typically, the transactions, arrangements or events lack economic substance and commercial reality and would not have materialized except for the tax result sought. The transactions, arrangements or events result in: sheltering income and capital gains that should be reported; creating or inflating tax deductions and losses, including capital losses, that would not otherwise exist; misusing treaty provisions; or accessing tax incentives, credits and exemptions in an offensive manner.
>
> Aggressive tax planning undermines the integrity of tax laws and the tax base.[4]

Business news in Quebec and elsewhere in Canada (as well as other countries) illustrates the significance of the issues inherent in aggressive tax planning for all stakeholders.

3 *The Queen v. Canada Trustco Mortgage Co.*, [2005] 2 SCR 601, at paragraph 16.

4 Canada Revenue Agency, *Summary of the Corporate Business Plan 2005-2006 to 2007-2008* (Ottawa: CRA, 2005), 16 (online: http://www.cra-arc.gc.ca/agency/business_plans/2005/sum_2005-2008_web-e.pdf).

In 2006, Quebec's tax administration amended the province's tax legislation to claim more than $500 million of income tax from trusts that engaged in an arrangement allowing their beneficiaries to avoid income tax payable to Quebec.[5] The need for the Quebec government to contain tax avoidance is amplified by concern for the funding requirements of public goods and services.

In 2007, the Canadian Department of Finance proposed new anti-avoidance measures to prevent companies from compounding the deductibility in Canada of interest paid on loans taken out to acquire stakes in foreign companies.[6] These measures were contested by the business community because (among other objections) they could make Canadian companies less competitive in international markets.[7] To deal with these concerns, the Canadian government has set up an expert panel to reconcile the objective of making the tax system fairer for all taxpayers with the objective of making Canadian companies more competitive in international markets.[8]

In addition, stakeholders in Canada continue to express diverging views on the scope of decisions reached by the courts, including the Supreme Court of Canada, on the application of the general anti-avoidance rule (GAAR).[9]

International Context

Turning to the situation abroad, Japan recently joined the ranks of Canada, Australia, the United States, and the United Kingdom as a participant in the Joint International Tax Shelter Information Centre (JITSIC). With this addition to JITSIC's membership, the exchange of information among these countries on new forms of aggressive tax planning, their promoters, and investors will likely increase.[10]

The auditor general of Canada and her counterparts in Australia, the United Kingdom, and the United States have expressed their concerns over the years about

5 Loi modifiant la Loi sur les impôts et d'autres dispositions législatives, 2006 LQ c. 13, notably sections 42 to 46. These amendments came into force on June 13, 2006 and apply retroactively.

6 Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, 420.

7 The government responded by issuing a revised and much narrower proposal focusing on the doubling up of interest deductions on borrowed funds channelled through foreign affiliates in low-tax jurisdictions (tax havens): see Canada, Department of Finance, "Canada's New Government Improves Tax Fairness with Anti-Tax-Haven Initiative," *News Release* 2007-041, May 14, 2007, and accompanying Backgrounder. For a concise account of the business community's objections to the government's proposal, see PricewaterhouseCoopers, "The Anti-Tax-Haven Initiative: An End to Double Dipping?" *Tax Memo*, May 15, 2007 (online: http://www.pwc.com/ca/eng/ins-sol/publications/tm_0507.pdf).

8 See Canada, Department of Finance, "Government Establishes Advisory Panel on Canada's System of International Taxation," *News Release* 2007-092, November 30, 2007. The advisory panel issued a consultation paper on April 25, 2008 (online: http://www.apesit-gcrefi.ca/os/cnpdcn-eng.html).

9 Section 245 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

10 Canada Revenue Agency, "Abusive Tax Schemes Tackled by International Tax Administrations," *News Release*, May 23, 2007.

abusive tax planning and the erosion of the domestic tax base. It is impossible to calculate the precise share of the tax gap that is attributable to aggressive tax planning in each country, since one cannot trace every conceivable avoidance transaction. Nevertheless, the overall figure for these countries may well be measured in terms of billions of dollars, in light of the amounts that their respective tax administrations have collected and the global value of their respective tax assessments pertaining to aggressive planning, notably in the field of international transactions and transfer pricing.

Factors Contributing to Aggressive Tax Planning

Various stakeholders have raised several motives that may explain why taxpayers and tax advisers enter into aggressive tax planning.[11] These range from a perceived disregard for civil duty or ethics to purely financial reasons. In the case of corporations, economic pressures stemming from investors' expectations have led in-house tax departments to become profit centres in their own right. Those pressures are exacerbated by globalization, which drives multinationals to enter into creative fiscal strategies designed to minimize their global effective tax rate. Increasing competition among tax advisers has led some to become tax shelter promoters, earning lucrative fees based on a percentage of the tax benefits to be claimed by their clients. Taxpayers, for their part, are willing—or enticed—to play the audit lottery.

From the perspective of taxpayers and tax advisers who engage in aggressive tax planning, it can be argued that they are merely availing themselves of the taxpayer's right to organize his affairs so as to minimize his tax burden. However, citizens, the media, and tax administrations are paying closer attention to the social responsibility of businesses, and to wealthy individuals and tax advisers who are undertaking tax planning beyond the boundaries of what the tax law truly allows.

PROTECTION OF THE TAX BASE: TOOLS EMPLOYED BY TAX ADMINISTRATIONS

Tax administrations can protect the integrity of their tax system in a variety of ways when dealing with aggressive tax planning. These include simplifying the tax system, reforming tax policies, and working with other jurisdictions toward international harmonization of their tax systems. However, to the degree that tax administrations consider it advisable to maintain the existing structure of their system, they will use various tools to protect the integrity of the tax base.

11 In January 2006, the research chair held a symposium in Montreal on the factors that can prompt taxpayers and tax advisers to engage in aggressive tax planning. Afterward, the chair published a paper providing a brief discussion of the major issues inherent in aggressive tax planning in Canada. At present, only the French version of the paper is available (online: http://www.usherbrooke.ca/adm/recherche/chairefiscalite/publications/cahiers/Evitement_fiscal_21juin2006.pdf).

Canada's GAAR: Strengths and Limitations

We believe that a general anti-avoidance rule, such as section 245 of Canada's Income Tax Act, is a useful tool that a tax administration can use to strike a balance between legitimate transactions and abusive tax planning. However, the application of GAAR by Canadian courts since its enactment in 1988 has exposed its limitations in a judicial system that favours a liberal construction of the tax law. As the CRA has observed,

> [t]he growth in abusive tax schemes, such as tax avoidance arrangements through liberal interpretations of Canada's tax laws, undermines public confidence in our tax system and may give the impression that tax avoidance and evasion are pervasive.[12]

In applying GAAR, the courts should in principle assess the purpose of taxpayers in an objective manner. However, the courts have discarded this application of GAAR on some occasions, on the grounds that, in the eyes of taxpayers, the primary purpose of a particular planning strategy was the realization of a commercial or economic purpose, regardless of any resulting tax advantages. As Bell J of the Tax Court emphasized in 2006, the courts will weigh the credibility of the taxpayer or other witnesses in determining the taxpayer's primary purpose in implementing an impugned transaction or arrangement. The following paragraphs of the decision in *MIL Investments* illustrate the weight that a court could attribute to the taxpayer's purpose, viewed subjectively, in applying GAAR:

> In determining the primary purpose of any transaction the credibility of witnesses is extremely important. Throughout the hearing, I observed and assessed, on a continuous basis, Boulle's demeanor, his delivery, his constant unchanging colour, his facial expressions and the absence of fidgeting, nervous behaviour. I also listened carefully to all his responses, both to the questions of his own counsel and on cross-examination. I concluded that he was credible.[13]

> It is apparent from the evidence that the reason for the sale was to realize a gain on the sale of a small portion of [Boulle's] DFR shares. Boulle was a "paper millionaire" with financial burden, his entire wealth being held in non-liquid shares of DFR. There was always the possibility of a substantial diminution in the value of his investment which had risen inordinately quickly in value. The sale ensured him of financial security, a *bona fide* purpose, regardless of the success or failure of DFR. This is the "why" for each transaction in the series. The "how" of the series was the implementation of a complex plan formulated by Appellant's Canadian tax counsel.[14]

12 Canada Customs and Revenue Agency, *CCRA Annual Report to Parliament 2004-2005* (Ottawa: CCRA, 2005), 17.

13 *MIL (Investments) SA v. The Queen*, 2006 DTC 3307, at paragraph 45 (TCC); aff'd. 2007 FCA 236.

14 Ibid. (TCC), at paragraph 50.

More specifically, on the basis of prior case law, Bell J concluded that a court must first assess *why* the taxpayer undertook the planning before assessing *how* that planning was implemented:

> I find it clear that, despite the possibility of the DFR shares already being exempt under the Treaty, one of the "driving forces" of the transactions was the Appellant's desire to ensure the sale of its shares in a tax effective manner. I conclude, however, that the "how" is subordinate to the "why" of the sale.
>
> This finding is consistent with the established jurisprudence on the legitimacy of seeking out tax planning, for example, *Geransky v. H.M.Q.*, 2001 DTC 243 established that:
>
> > . . . a purely commercial transaction conceived by business persons without any particular tax motivation and carried out with the assistance of tax professionals in a manner that is designed to achieve that result with the least unfavorable tax consequences
>
> is not an avoidance transaction.[15]

> This principle derives from the seminal case of *IRC v. Duke of Westminster* (1935), 19 T.C. 490 where Lord Tomlin said:
>
> > Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[16]

The courts will apply the Act in favour of taxpayers where the objects of the law are not clearly apparent. As the Supreme Court of Canada stated in *Canada Trustco*, the application of the abuse-of-law criterion has sparked much debate among all stakeholders, given that the law does not clearly define what kind of aggressive planning amounts to an abuse of law:

> The third requirement for application of the GAAR is that the avoidance transaction giving rise to a tax benefit be abusive. The mere existence of an avoidance transaction is not enough to permit the GAAR to be applied. The transaction must also be shown to be *abusive* under s. 245(4).
>
> It is this requirement that has given rise to the most difficulty in the interpretation and application of the GAAR. A number of features have provoked judicial debate. The section is cast in terms of a double negative, stating that the GAAR does "not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse . . . or an abuse." It is tempered by the word "reasonably," suggesting some ministerial and judicial leeway in determining abuse. It does not

15 Ibid., at paragraph 53.

16 Ibid., at paragraph 55.

> precisely define abuse or misuse. To further complicate matters, the English and French versions of s. 245(4) differ. Overarching these particular difficulties is the central issue of the relationship between the GAAR and more specific provisions of the Act.[17]

From a tax policy perspective, the manner in which the courts have applied GAAR raises several issues pertaining to predictability, consistency, and fairness in the application of the law. Two years after *Canada Trustco*, the Supreme Court of Canada has heard the appeal in *Lipson*,[18] another GAAR case. The issue in *Lipson* is the Tax Court's application of GAAR based on the economic substance of a series of transactions. Essentially, the Tax Court disqualified tax planning that complied with the literal terms of specific provisions, on the basis of the overall scheme of the Act and the economic substance of the whole series of transactions.[19]

Our study of tools used by selected trading partners leads us to the conclusion that GAAR could be adjusted to achieve greater predictability, consistency, and fairness. This study has also instructed us that GAAR is merely a means to an end (tackling abusive tax planning). And just like any other tool, a general anti-avoidance rule or doctrine has its strengths and its limitations.

The main strength of a general anti-avoidance rule or doctrine is flexibility in its application, to ensure that it protects the integrity of the law in the face of all kinds of abusive tax planning implemented by taxpayers over time. On the downside, this flexibility implies a degree of uncertainty when the tax administration cannot establish sound and practical guidelines to clearly delineate the boundaries between legitimate tax-saving transactions and abusive tax planning.

Just like Canada, our selected trading partners have struggled, to varying degrees, with the difficulty of applying a highly complex technical tax law that takes into account objects and purposes. We believe that certain tools of these trading partners have allowed the tax administration and the courts to reach an appropriate balance between legitimate transactions and abusive tax planning, even where confronted with the difficulty of establishing the purpose of the law through incoherent

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17 Supra note 3, at paragraphs 36-37. The amendment of subsection 245(4) (SC 2005, c. 19, section 52(2)) has removed the double-negative formulation noted by the court. As a result, GAAR

> applies to a transaction only if it may reasonably be considered that the transaction
> (a) would . . . result directly or indirectly in a misuse . . . ; or
> (b) would result directly or indirectly in an abuse.

That change had already been enacted when the Supreme Court rendered its judgment in *Canada Trustco*. Although the amendment did not apply in that case, the court stated in its judgment that "even if this amendment were to apply, it would not warrant a different approach to the issues on appeal": supra note 3, at paragraph 7.

18 *Lipson v. The Queen*, [2006] 3 CTC 2494 (TCC); aff'd. 2007 FCA 113; appeal heard by the Supreme Court of Canada on April 23, 2008, judgment reserved.

19 See the analysis of the Federal Court of Appeal, ibid., at paragraphs 25-52.

technical rules. We are also of the view that any adjustment to GAAR should be made taking into account pragmatic considerations for all stakeholders in its application.

Furthermore, we are of the view that any stand-alone GAAR merely traces the boundaries between what is considered acceptable and what is not. It is the nature of the consequences that taxpayers may incur if they are reassessed by the tax administration on the basis of the application of a general rule that will lead some to implement, or refrain from, aggressive tax planning. The deterrent effect of a general rule resides in the ability of the tax administration to trace within the prescribed period those taxpayers who implemented aggressive tax planning potentially subject to the general rule. Over time, the efficiency of a general rule rests upon its fair and coherent application by the tax administration and the courts.

Canada already has tools to target taxpayers and tax advisers who might undertake aggressive tax planning.[20] However, we are of the view that the application of these tools is infrequent and uncertain at best. We believe that Canada should take into consideration the experience of its trading partners in managing risks embodied in aggressive tax planning. Canada could therefore tailor an approach to tax avoidance that reflects the positive outcome of the tools that have proved useful in other jurisdictions, while avoiding the pitfalls that some have encountered.

Tools Used by Selected Trading Partners

Our study examines a number of significant tools developed by Australia, the United Kingdom, the United States, and the European Union. Our analysis takes into account the distinguishing features of each country's tax system and the context that led to the development of these tools. In view of the scope of the subject, its complexity, and the diversity of national tax systems, our study should be seen as a reflection on aggressive tax planning rather than an exhaustive analysis of each of the tools examined and all associated issues.

In view of the wide array of tools available, we have limited our research project to a few mechanisms that have attracted considerable attention in recent years, specifically the following:

- the doctrine of abusive practice in the European Union;
- Australia's GAAR and the application of a tax understatement penalty;
- the project to codify the economic substance doctrine in the United States (often applied, currently, in US courts), and the application of tax understatement penalties;
- disclosure rules in the United Kingdom and the United States;
- ethical standards in tax matters in the United States; and
- settlement offers in the United States.

20 Notably, the tax shelter registration rules (section 237.1 of the Act), the penalty for false statements or omissions (subsection 163(2)), and the penalty for misrepresentation of a tax matter by a third party (section 163.2).

We have selected these tools because they have generated heated discussions and debate in a wide range of forums—government position papers, independent commission reviews, papers by major players among tax advisers, briefs presented by professional bodies and trade organizations, academic studies, and publications of international organizations such as the Organisation for Economic Co-operation and Development.

ANALYTICAL FRAMEWORK

Generally Recognized Administration Principles

We assess in our study whether it would be worthwhile for Canada to adopt some of these tools to further protect the integrity of its tax system. As indicated earlier, in doing so, we consider the standpoints of taxpayers, tax advisers, the tax administration, and the courts, according to generally recognized tax administration principles (described below). From the standpoint of the tax administration, we seek to define the role of each of these instruments within the tax administration's usual intervention methods—which we refer to as "spheres of intervention"—with respect to aggressive tax planning.

The study framework that we developed to navigate through the selected foreign tools is shown in table 1. The table sets out the major concerns of each group of stakeholders in relation to four principles that are generally applied by tax administrations in counteracting aggressive tax planning. These principles are

- *predictability* and *simplicity* in the application of the tax rules;
- *effectiveness* (transparency) of the rules for disclosure of information by taxpayers and their tax advisers; and
- *fairness* in the scope of anti-avoidance rules, including compliance and enforcement.

Spheres of Intervention of Tax Administrations

For purposes of our study, the tools available to tax administrations in countering aggressive tax planning are divided into four spheres of intervention:

- tools that define tax-avoidance arrangements;
- tools to enhance enforcement of tax rules;
- tools designed to detect aggressive tax-planning schemes and identify their participants; and
- tools that focus on resolving disputes.

Figure 1 concisely illustrates the relation between these spheres of intervention in managing the risks inherent in aggressive tax planning. Each of the foreign tools selected for our study is located in a sphere of intervention on the basis of its detailed application, which will be explained at length in our upcoming articles.

By mapping the relation between the spheres of intervention, figure 1 allows us to tailor a Canadian approach to tax avoidance based on the tools of one or more

TABLE 1 Aggressive Tax Planning: Stakeholders' Concerns in Relation to Accepted Principles of Tax Administration

	Stakeholder group			
Principle	Taxpayers	Tax advisers	Tax administration	Courts
Predictability	The proliferation of tax rules creates grey zones in the interpretation of tax law. Taxpayers must deal with uncertainty as to the threshold of probability required for a legal or factual interpretation to comply with tax law. The difficulties involved in estimating the results of a complex and lengthy court case make taxpayers more uncertain as to their financial situation and, ultimately, can undermine investor confidence.	The proliferation of tax rules and interpretation principles in the jurisprudence creates grey zones in the interpretation of tax law. Tax advisers are still uncertain regarding the ethical standards that apply to them.	Grey zones in the interpretation of tax law leave room for many reasonable interpretations. Taxpayers could resort to aggressive tax planning if the degree of uncertainty correspondingly reduces the chances of being audited. Competition among tax advisers may prompt some of them to continue developing new aggressive tax-planning schemes. The difficulty of estimating precisely the results of a complex and lengthy court case and all its inherent uncertainties can jeopardize collection of tax revenues and add to the uncertainty of taxpayers and tax advisers while the case is before the court.	Uncertainty as to the scope of the tax rules makes interpretation of the rights and duties of taxpayers, tax advisers, and the tax administration all the more difficult to rule on.
Simplicity	The tax rules should be developed and formulated in flexible terms so that their interpretation is not time-dependent but evolves with the economic sector. The costs inherent in understanding the tax rules and complying with them, as well as in audit and objection procedures, are onerous for taxpayers.	Ongoing analysis of all the issues relating to aggressive tax planning requires substantial resources. The role played by tax advisers in their clients' tax risk management strategy is changing.	The costs inherent in audit and legal proceedings regarding aggressive tax planning are significant and the results are not always predictable.	The complexity, multiplicity, and lack of consistency of the tax rules produce uncertainty in identifying the objectives of the law.

(The table is continued on the next page.)

TABLE 1 Continued

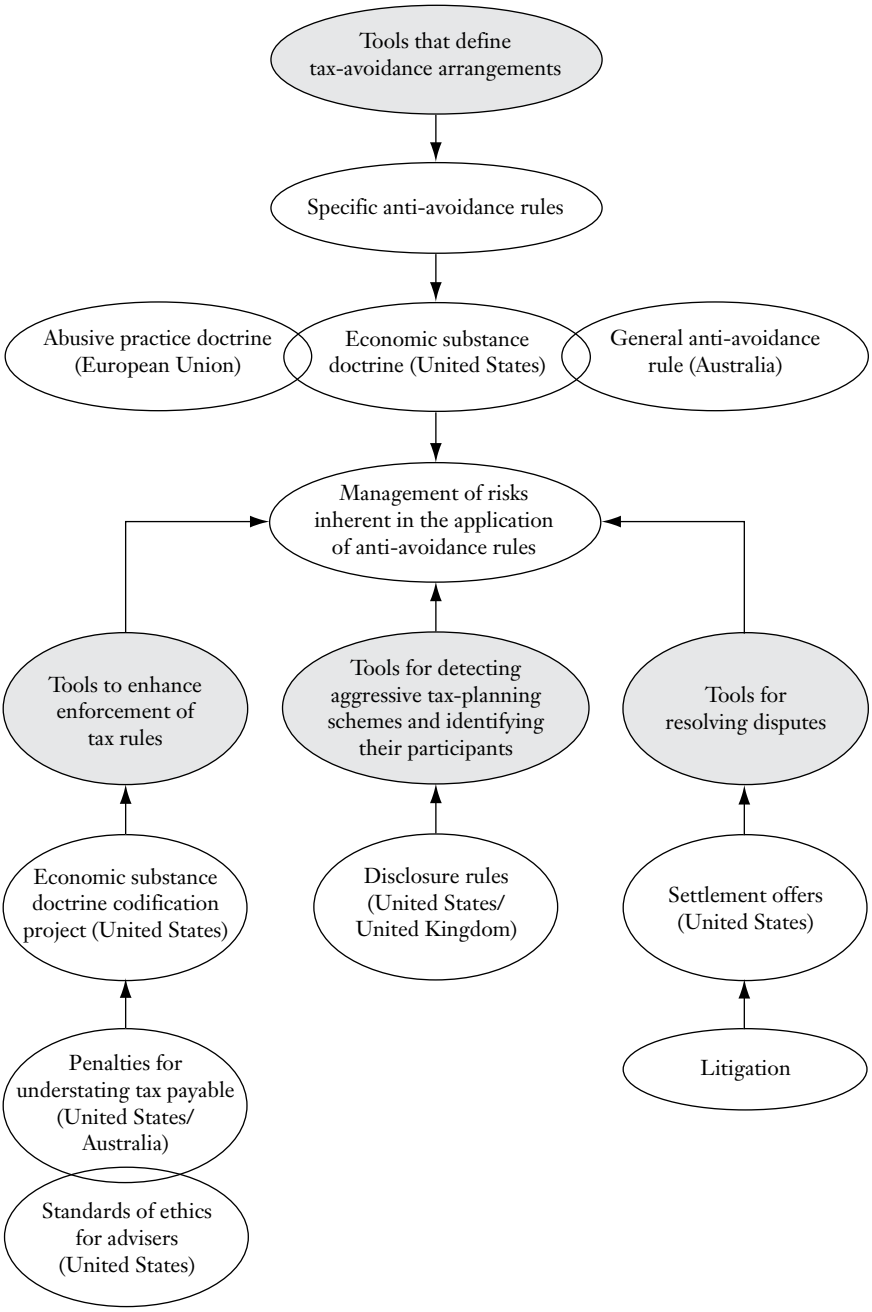
	Stakeholder group			
Principle	Taxpayers	Tax advisers	Tax administration	Courts
Effectiveness of disclosure rules	Taxpayers provide the tax administration with a large amount of information in their tax returns and other information returns. These obligations are costly and time-consuming in terms of human resources. Taxpayers should be able to confidentially disclose to their tax advisers all the facts needed to ensure compliance with the tax rules, including information regarding trade processes or secrets.	Tax advisers must protect the privilege of confidential communication with their clients when faced with a demand for information from the tax administration.	The tax administration must have the necessary resources and optimize them to deal with the growing phenomenon of aggressive tax planning. Currently, the tax administration is unable to deploy all necessary resources to audit the tax returns of all taxpayers within the period of limitation. Tax and information returns do not always provide the data necessary to detect aggressive tax planning. Taxpayers' confidentiality privileges can, in many cases, undermine the efforts of the tax administration to detect aggressive tax-planning schemes.	The courts must reconcile the audit powers of the tax administration with taxpayers' confidentiality privileges.

(The table is concluded on the next page.)

TABLE 1 Concluded

	Stakeholder group			
Principle	Taxpayers	Tax advisers	Tax administration	Courts
Fairness	The tax administration could make abusive use of anti-avoidance measures and infringe on the rights and privileges of taxpayers. The scope of anti-avoidance measures could inadvertently include legitimate business arrangements, particularly if these measures are not applied with flexibility in light of the facts of each arrangement. Anti-avoidance measures could add an unfair burden to the tax system's compliance duties for taxpayers, particularly small multinational enterprises and individuals. The eventual application of a penalty could be inappropriate or disproportionate, since there can be many reasonable interpretations of the tax rules (given the uncertainty as to their scope).	Tax advisers should not be held liable when their clients knowingly resort to aggressive tax planning without having consulted with their adviser. Penalties may be inappropriate or disproportionate where ■ grey zones in the law allow for many reasonable interpretations; ■ taxpayers do not disclose all the facts relating to a tax-planning scheme; or ■ advisers want to avoid soliciting their clients for the implementation of aggressive tax-planning schemes. Advisers must have the opportunity to protect their clients' confidentiality privileges against intrusion by the tax administration.	The tax administration does not have the necessary resources to target all potential tax-avoidance arrangements, since an audit must also include the examination of legitimate business arrangements. Tax penalties would be more effective if they could be changed to take into consideration differences in the nature of current tax-avoidance arrangements.	In view of the concerns expressed by the other stakeholders, the courts must reconcile the rights and privileges of taxpayers and tax advisers with the legitimate powers of the tax administration to infringe or limit those rights and privileges. The courts must also reconcile the right of taxpayers to minimize their tax with the achievement of the objectives of the tax law.

FIGURE 1 Spheres of Intervention and Selected Tools Used by Trading Partners To Counter Aggressive Tax Planning



jurisdictions. The approach could borrow features of the tool that one jurisdiction uses to define tax avoidance while following the approach taken by another jurisdiction under either one of the other spheres of intervention.

ASSESSMENT OF TOOLS USED BY TRADING PARTNERS

Our study within the parameters reflected in table 1 leads us toward a variety of conclusions about the effectiveness of various legal approaches to aggressive tax avoidance.

As indicated earlier in this article, tax administrations could simplify the tax system or change their tax policies to reduce opportunities for tax avoidance. They could also make these opportunities financially less attractive—for instance, by partially replacing corporate income tax with an increase in sales taxes. While these approaches are relevant, they lie outside the scope of this study.

If tax administrations consider it advisable to maintain the current structure of their tax system, they can adopt tools to offset the tax benefits arising from tax-avoidance arrangements or to increase the risk for aggressive advisers and for taxpayers. This strategy is reflected in the anti-avoidance tools examined in this study.

As figure 1 shows, the tools studied are distributed among all spheres of tax administration intervention. For example, trading partners may use anti-avoidance rules or judicial doctrines that the tax administrations and the courts may apply to deny taxpayers the benefits of tax advantages that they claim on the basis of a literal interpretation of the law. The application of these tools by the tax administration and the courts rests upon the nature of the taxpayer's purposes in carrying out aggressive tax planning and upon the weight of the tax purpose relative to the weight of other purposes. These anti-avoidance rules and doctrines take into consideration the economic substance of the arrangements in various ways. They provide flexibility for all stakeholders to draw the line between legitimate tax planning and abusive tax avoidance, taking into account the circumstances of each taxpayer. On the other hand, flexibility leads to uncertainty for taxpayers and their advisers in predicting the application of these tools by the tax administration and the outcome of a court's decision. The lack of objective factors in the law, or their lack of precision, lies at the heart of this unpredictability. The ultimate goal for tax administrations is to strike the right balance between flexibility and predictability, and to apply the available tools in a coherent manner, in keeping with the purposes of the law.

We observe that in some cases taxpayers are liable for a penalty for understating tax payable where these anti-avoidance rules or doctrines apply. A penalty must create a genuine financial disincentive for taxpayers and their advisers to engage in avoidance activities. However, taxpayers and their advisers will refrain from entering into aggressive tax planning only to the extent that tax administrations have the tools to effectively detect these arrangements and to apply penalties. The fairness of any penalty that may be applied by the tax administration depends on the circumstances under which a court may or may not uphold the penalty.

The efficiency of anti-avoidance rules, of judicial doctrines, and of penalties for understatement of taxes rests upon the ability of tax administrations to trace in a timely fashion the abusive tax-planning arrangements undertaken by taxpayers and their advisers. Disclosure rules may assist tax administrations in detecting taxpayers and advisers who have engaged in aggressive tax planning. Early detection of tax planning following its implementation by taxpayers and their advisers allows tax administrations to quickly enact specific anti-avoidance rules to block a given abusive scheme and to track other taxpayers who have implemented that scheme. For tax administrations, disclosure rules may patch the usual time lag between the implementation by taxpayers of an abusive scheme and the filing of their annual tax returns, which may not provide all the details required for a complete assessment of the abusive nature of a taxpayer's planning. The efficiency and fairness of disclosure rules rest upon the ability of tax administrations to minimize the administrative burdens of taxpayers and their advisers who undertake current commercial operations. Tax administrations may choose to lower any applicable understatement penalty as a way of enticing taxpayers and their advisers to disclose detailed information on aggressive tax planning in a timely manner immediately after they put the plan in place.

The application of each of the above-mentioned tools is fact-intensive. Lengthy trials to determine whether a tax-planning scheme is abusive can be costly and time-consuming for both taxpayers and tax administrations. Tax administrations could issue settlement offers to taxpayers, which may allow both groups of stakeholders to effectively manage risks embodied in aggressive tax planning. Tax administrations can recover tax revenues from taxpayers engaged in aggressive tax planning by reducing or voiding any applicable penalty, as long as those taxpayers agree to the terms of a settlement offer. The viability of this tool in the long run rests upon the tax administration. Unfair and inflexible settlement terms where tax administrations systematically raise the spectre of a high understatement penalty will undermine the efficiency of this tool in the long run. The effectiveness of this tool depends largely on the probability that the tax administration will issue notices of assessment to taxpayers, and that tribunals will strike down abusive tax planning and apply tax understatement penalties.

Lastly, as a general rule, taxpayers are the focus of the foreign tools selected for the study. However, we note that tax advisers can be subject to disclosure rules and even standards of ethics in tax matters. As figure 1 indicates, disclosure rules can play a primary role in detecting aggressive tax-planning schemes and identifying their participants. We believe that tax advisers should provide tax advice following ethical standards tailored to aggressive tax-planning situations. Nevertheless, standards of ethics in tax matters appear, in our view, to be of lesser importance than a penalty on taxpayers for understating tax payable under a self-assessment system.

An overarching approach across all spheres of intervention of the tax administration significantly increases the risk for taxpayers and tax advisers regarding aggressive tax planning. The American approach best exemplifies the interactions between all the spheres of intervention, and the need for predictability in the application of the tax law. The tools selected for this study play a role in each of the spheres of intervention of the American tax administration. However, uncertainty over the economic

substance doctrine developed by the American courts is the basis for the various codification proposals made over the years by the tax administration. This uncertainty has an impact on taxpayers and tax advisers faced with the tax administration's application of the tools in each sphere of intervention, since the question of economic substance is central to the differences of opinion among stakeholders.

In light of the role of the foreign tools within the tax administration's spheres of intervention and the principles of tax administration described above, in our forthcoming articles we will assess whether it would be worthwhile for Canada to implement some of these tools.