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Saul Templeton\*

## A Defence of the Principled Approach to Tax Settlements

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*The Canadian Minister of National Revenue is responsible for administering and enforcing the majority of tax legislation in Canada. Where disputes arise with particular taxpayers over the correct amount of tax owed, the taxpaying public ought to have confidence that the Minister has a principled basis in law for settling disputes for less than amounts previously assessed. Yet opponents of the principled basis for settlement consistently call for reform, arguing that compromise settlement should be permissible.*

*This paper responds to arguments raised for compromise settlement by reconciling the jurisprudence on the authority of the Minister to settle tax disputes. It then challenges the Carter Commission's recommendation that U.S.-style offers in compromise should be available in Canada. Exercise of existing Ministerial discretion to grant advance rulings and taxpayer relief has been inconsistent, demonstrating that additional discretion would only deepen public suspicion that the tax system is administered unfairly.*

*Au Canada, la responsabilité d'administrer et d'appliquer la majorité des mesures législatives en fiscalité incombe au ministre du Revenu national. Lorsque surviennent des différends avec des contribuables relativement au montant d'impôt à payer, les autres contribuables doivent avoir la certitude que le ministre peut s'appuyer sur une base juridique pour régler les différends pour des montants inférieurs à la cotisation initiale. Pourtant, les opposants à cette façon de faire réclament continuellement une réforme, alléguant qu'un règlement sur la base d'un compromis devrait être permis.*

*L'auteur répond aux arguments avancés en faveur du règlement amiable en rapprochant la jurisprudence sur l'autorité du ministre de régler les différends d'ordre fiscal. Il conteste ensuite la recommandation de la Commission Carter que des offres de règlement similaires à ce qui se fait aux É.-U. devraient être disponibles au Canada. L'exercice du pouvoir discrétionnaire ministériel actuel pour accorder des décisions anticipées et des allègements aux contribuables a été incohérent, preuve qu'un pouvoir discrétionnaire accru ne ferait qu'alimenter les soupçons du public que le régime fiscal est administré inéquitablement.*

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I. *The principled approach under siege*

Public confidence in the administration and enforcement of taxes is a cornerstone of self-assessing tax systems.<sup>1</sup> The Canadian Minister of

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1. The author relies on the assumption that public confidence in tax administration is a necessary component of effective tax systems, and indeed a necessary component for public confidence in governments themselves. While other factors also influence compliance, much of the literature on improving tax compliance mentions confidence in the administration of taxes as a key factor. See, e.g., OECD, Centre for Tax Policy and Administration, *Compliance Risk Management: Managing and Improving Tax Compliance*, (OECD, October 2004), online: OECD <[www.oecd.org/tax/administration/33818656.pdf](http://www.oecd.org/tax/administration/33818656.pdf)> and US, Government Accountability Office, *Tax Gap: Complexity and Taxpayer Compliance* (GAO-11-747T), (Washington, DC: GAO, 2011) at 1, online: GAO <[www.gao.gov/assets/130/126530.pdf](http://www.gao.gov/assets/130/126530.pdf)>: "Public confidence in the nation's tax laws and tax administration is critical because we rely heavily on a system of voluntary compliance. If taxpayers do not have confidence in the tax system or do not believe that it is easy to understand and treats everyone fairly, then voluntary compliance is likely to decline."

National Revenue (the Minister), through the Canada Revenue Agency, is entrusted with the responsibility of administering and enforcing the majority of tax legislation in Canada. Where disputes arise with particular taxpayers over the correct amount of tax owed, the general taxpaying public ought to have confidence that the Minister has a principled basis in law for settling disputes for less than amounts previously assessed. It must be possible to find the tax consequences agreed upon in compliance with a reasonable interpretation of a tax statute as it applies to the taxpayer's circumstances.<sup>2</sup> This norm is expressed in both the statutory provisions from which the Minister draws her authority,<sup>3</sup> and in the bulk of jurisprudence interpreting the application of those provisions to tax settlements in issue before the courts.<sup>4</sup> The requirement that tax settlements have a principled basis in law is a necessary check against the possibility that the discretion of the Minister, through her individual agents, will be exercised in an inconsistent manner. Instances where the public has become aware of even the possibility that ministerial discretion has been exercised in a capricious or preferential manner have resulted in protracted, widely publicized criticisms of the Minister and the Canada Revenue Agency (CRA).<sup>5</sup> It is reasonable to assume that these media storms cause some loss of public confidence in the administration of the Canadian tax system. Thus the risk

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2. The principled approach to tax settlements prevents the taxpayer and the Minister from simply splitting the difference in dispute. There must be a legal justification for settling on an amount agreed to by the parties. Most tax disputes are disputes about facts and how they ought to be characterized according to the law, so it is possible to reach an agreement that some facts be characterized as the taxpayer sees them and others as the Minister sees them.

3. At the time of writing, the position of Minister is held by the Honourable Kerry-Lynne D Findlay. The Minister's obligation to "administer and enforce" tax legislation is found in the *Income Tax Act*, RSC 1985, c 1 (5th Supp), s 220 [ITA] and the Minister was found to be bound by the same principle in administering the *Excise Tax Act*, RSC, 1985, c E-15 [ETA] in *CIBC World Markets Inc v Canada*, 2012 FCA 3, 2012 GTC 1011 [CIBC World Markets, 2012].

4. A notable exception is *Consoltex Inc v R* (1977), 97 DTC 724 (TCC) [Consoltex], discussed below.

5. Most recently, the CRA has been criticized in the media for allegedly targeting left-leaning and environmental charitable organizations for audit of their charitable status. It is impossible to know whether, or to what extent, the CRA has been subject to political pressure to target charities on ideological grounds. However numerous news reports and public complaints by left-leaning charitable organizations have led the Broadbent Institute to release a report: Broadbent Institute, "Stephen Harper's CRA: Selective Audits, 'Political' Activity, and Right-Leaning Charities" (October 2014), online: Broadbent Institute <[https://www.broadbentinstitute.ca/sites/default/files/documents/harpers-cra-final\\_0.pdf](https://www.broadbentinstitute.ca/sites/default/files/documents/harpers-cra-final_0.pdf)>. Thus, even the perception of unfairness in the exercise of ministerial discretion (in this case, the discretion to choose targets for audit) is damaging to the public's confidence that the CRA is administering tax legislation in an equitable manner. Further, the fact that the CRA manages (or, on the contrary view, mismanages) discretion to choose the taxpayers it will audit is not a reason to expand ministerial discretion to areas where discretion is unnecessary. Discretion to choose audit targets is a necessary concession to the administrability of the tax system, since the CRA cannot assess everyone, or effectively enforce the tax system by auditing no one.

of harm from inconsistent exercise of ministerial discretion is twofold: first, discretion exercised inconsistently by agents of the Minister results in inequity between taxpayers; second, media coverage of real or perceived inconsistencies in the exercise of ministerial discretion results in a loss of public confidence in the tax system. In the context of tax settlements, the potential for inequitable treatment of taxpayers is significant. The willingness of individual agents of the Minister to settle on terms more or less favourable to a particular taxpayer will vary based on the individual characteristics of the agents themselves, and on the propensity of each taxpayer to prolong disputes with the Minister either on their own or with the aid of tax professionals. The principled approach does not guarantee that taxpayers will be treated consistently in the process of settling tax disputes. However, it mitigates the risk that settlement amounts will be arbitrary if concluded on a compromise basis.<sup>6</sup>

Despite the apparent value of requiring a principled basis in law for settling tax disputes, and despite Canadian courts' regular insistence on principled basis settlements, the principled basis for tax settlements remains controversial. It is frequently proposed that the Minister's authority ought to be expanded so that compromise settlements can be struck without black letter statutory justifications for the agreed upon tax consequences. The requirement that tax settlements have a principled basis in law was critiqued in the 1966 *Report of the Royal Commission on Taxation*, a foundational report on tax policy in Canada.<sup>7</sup> Calls for reform have been made by tax academics and practitioners on a fairly consistent basis since that time.<sup>8</sup>

This paper adds to the debate on the principled basis for settlement by drawing on the significant criticism of ministerial discretion in the context of advance rulings and taxpayer relief from interest and penalties,<sup>9</sup> and by

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6. For example, in *Galway v MNR*, [1974] 1 FC 600 (FCA) [*Galway 2*] the Minister had agreed to settle the taxpayer's debt by assessing him as owing \$100,000 in respect of both interest and taxes. This was clearly an unprincipled settlement, since there is nothing to indicate that the Minister calculated what quantum of tax owing would give rise to interest in an amount that would add up to \$100,000, or considered the legal basis for assessing that amount of tax. (Note there is more than one FCA *Galway* decision in 1974.)

7. Canada, *Report of the Royal Commission on Taxation*, vol 5, Chair: Kenneth LeM Carter (Ottawa: Queen's Printer, 1966) [*Carter Report*].

8. For example, the call for settlement on a more commercial basis was renewed in Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) at 10.8. Academics have argued for compromise-basis settlements more recently in Daniel Sandler & Colin Campbell, "Catch-22: A Principled Basis for the Settlement of Tax Appeals" (2009) 57:4 Can Tax J 763 and Colin Jackson, "Settlement and Compromise in Canadian Income Tax Law Since Carter" in Kim Brooks, ed, *The Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later* (Toronto: Carswell, 2013) 295.

9. Ministerial discretion to cancel or waive interest and penalties is granted by the *ITA*, *supra* note

applying those criticisms to the expansion of ministerial discretion in the context of tax settlements. Ministerial discretion to grant or deny advance rulings was the subject of scathing criticism in the *Carter Report*,<sup>10</sup> so it is surprising that the same report would propose, albeit in a single paragraph, expanding ministerial discretion in the realm of tax settlements.<sup>11</sup> Ministerial discretion to waive or cancel taxes would be redundant in light of mechanisms already available to reduce taxpayers' debts through negotiations with the Minister's collections officials, taxpayer relief applications (for reducing interest and penalties), bankruptcy proceedings, and, in exceptional circumstances, remission orders. These mechanisms are all in addition to the ability to conclude principled-basis tax disputes.

There is a positive case to be made for requiring a principled basis for tax settlements. As outlined above, the principled approach better ensures that public confidence in the fairness of tax administration will be protected, even if information about particular settlement agreements becomes public.<sup>12</sup> The principled basis also protects horizontal and vertical equity.<sup>13</sup> Similarly situated taxpayers are not at risk of being treated

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3, s 220(3.1), but there is no ministerial discretion to cancel or waive taxes in the settlement process. Remission orders will be discussed below.

10. See *Carter Report*, *supra* note 7 at 117-129.

11. The Carter Commission's proposal is at *Carter Report*, *supra* note 7 at 149.

12. It would be difficult to gather empirical data about the relationship between tax compliance and confidence in the fair administration of the tax system, since people who do not comply with tax laws are unlikely to report their own failure to comply. One study in the US instead measured "tax ethics" as demonstrated by responses ranking the seriousness of various types of tax non-compliance. The study also asked respondents how many other taxpayers they thought were non-compliant on a number of tax offenses. Suspicion that many others were cheating on their taxes was correlated with low tax ethics. This might suggest that when taxpayers believe others are getting away with lowering their own tax burdens unfairly (as where public confidence in the fairness of tax administration is eroded), they are less likely to view tax non-compliance as a serious offense, and potentially more likely to fail to comply themselves. See Young-dahl Song & Tinsley E Yarbrough, "Tax Ethics and Taxpayer Attitudes: A Survey" (1978) 38:5 *Public Administration Rev* 442. See especially at 446-447.

13. These principles, in particular horizontal equity, are contested. The problems with determining who is similarly situated for the purpose of applying horizontal equity are discussed by David Elkins, "Horizontal Equity as a Principle of Tax Theory" (2006) 24:1 *Yale L & Pol'y Rev* 43, which points out that horizontal equity attempts to treat similarly well-off taxpayers equally, even though there is disagreement over what it means for taxpayers to be similarly well-off. See also, Paul R McDaniel & James R Repetti, "Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange" (1993) 1:10 *Fla Tax Rev* 607, discussing the Musgrave/Kaplow debate on whether horizontal and vertical equity have any normative content, and concluding that they do not and must be underpinned by independent theories of justice. Vertical equity is generally accepted since it is underpinned by theories of social and distributive justice, and one of the goals of the income tax is redistribution of resources in the economy (Brian Galle, "Tax Fairness" (2008) 65:4 *Wash & Lee L Rev* 1323 at 1324. Horizontal equity is more controversial, since it requires an assumption that the pre-tax distribution of income is just. It might not be equitable, under a social or distributive justice theory, to collect the same amount of tax from two taxpayers when one of them put in greater effort, education and time but received the same income. Market distributions of income have no moral status, therefore there is no justification for preserving equity of after-tax distributions between similar pre-tax incomes. See

differently if the Minister splits a tax liability with one of them on the basis of litigation risk (a factor that is irrelevant for the purposes of determining a correct amount of tax owing). Taxpayers with greater resources, and access to representation by tax professionals, will not be able to pressure the Minister into settlement solely on the basis of greater litigation risk. Canadian taxpayers have the right to expect that tax settlements concluded behind closed doors comply with tax laws.<sup>14</sup> No taxpayer should be above tax law by virtue of negotiating an unprincipled compromise on tax assessed.<sup>15</sup>

## II. *The legal backdrop: Statutory and judicial authority for limits on the Minister's discretion*

Subsection 220(1) of the *ITA* provides that the Minister “shall” administer and enforce the Act. Canadian courts have interpreted this provision narrowly, to disallow the Minister to assess taxpayers other than in accordance with the *ITA*.<sup>16</sup> In the context of ministerial discretion to

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the summary of critiques of horizontal equity, *ibid* at 1334-1335. As a practical matter, it seems it would be difficult for tax legislators and administrators to determine how two people with similar income from a similar source should be taxed differently. There are many examples in Canada where benchmarks for determining which taxpayers are similarly situated appear unjust. For example, wages result in an inclusion of employment income, but someone who receives the same amount of money as an inheritance will not have to include it in income, even though both taxpayers are better off by the same dollar amount. Any attempt to define a benchmark for who should be treated equally for tax purposes will be subject to debate. For a discussion of the baseline, policy and computational indeterminacies that undermine the claim that similarly situated taxpayers will be equitably treated in tax assessed, see Shu-Yi Oei, “Getting More by Asking Less: Justifying and Reforming Tax Law’s Offer-in-Compromise Procedure” (2012) 160:4 U Pa L Rev 1071 at 1086-1093. Even assuming that horizontal equity has no normative justification from a market distribution perspective, and that tax assessed is subject to indeterminacies, it does not follow that a solution to these problems can be found in the expansion of ministerial discretion to settle tax disputes on the basis of litigation risk. If anything, such discretion would introduce an additional indeterminacy in assessing tax liabilities. Use of the principle of horizontal equity throughout this paper assumes it is possible to determine similar tax liabilities for similarly situated taxpayers under existing legislation. The Minister must administer and enforce tax statutes that make some attempt at measuring tax assessed in a manner that accords, however imperfectly, with the values of Canadians as expressed in enactments of Parliament. Additional ministerial discretion to compromise on tax liabilities will not make the tax system more equitable as between similarly situated taxpayers. This is true whether “similarly situated” takes its meaning from income and tax as assessed by the tax statutes we have, or from a broader theory of distributive justice that it is probably safe to say the Minister and her agents are not equipped to apply consistently in the tax dispute resolution process.

14. As will be discussed below, settlements concluded on consent to judgment are public since they require a court to issue a decision approving the settlement. Other pre-trial forms of settlement remain confidential.

15. The author acknowledges that “rule of law” (alluded to) and “rights” as used here are not uncontested concepts as they apply to taxation. This paragraph should reveal, however, the normative assumptions from which argumentation will flow in this paper. For a theoretical discussion of normative frameworks in tax, see e.g. Sagit Leviner, “The Normative Underpinnings of Taxation” (2012) 13:1 Nevada LJ 95.

16. See *Ludmer v Canada*, [1995] 2 FC 3 (FCA) [*Ludmer*] and *Harris v Canada*, [2000] 4 FC 37

administer the *ITA* by issuing advance tax rulings, the Federal Court of Appeal in *Harris v. Canada* contrasted the narrow discretion granted by the *ITA* to the broad discretion granted by tax legislation in Britain.<sup>17</sup> *Harris* cites the House of Lords interpreting the statutory wording, “[i]ncome tax... shall be under the care and management of the Commissioners”<sup>18</sup> to grant “wide managerial discretion as to the best means of obtaining for the national exchequer from the taxes committed to their charge the highest net return that is practicable having regard to the staff available to them and the cost of collection.”<sup>19</sup> In other words, the U.K. system allows for tax settlements on the basis of litigation risk, while the Canadian system does not recognize tax settlements unless their terms are justifiable under substantive tax law. *Harris* approves of the characterization of Canadian powers to administer the *ITA* in *Ludmer v. Canada*,<sup>20</sup> stating that “[n]either the Minister of National Revenue nor his employees have any discretion whatever in the way in which they must apply the [*ITA*]. They are required to follow it absolutely.”<sup>21</sup> As will become clear, this requirement is rarely a bar to settling a tax dispute. Where the dispute is rooted in the facts of a case, there are typically multiple transactions or amounts in dispute over multiple taxation years, and it is possible for the Minister to concede some tax owing by finding a factual basis to characterize some transactions or amounts in a manner that is more favourable to the taxpayer. It is where cases are rooted in interpretations of law that they are difficult—if not impossible—to settle. There is value in litigating such cases, since the law is developed and clarified through court decisions on issues of law.

### 1. *Methods of settlement*

The requirement for a principled basis in law is not a bar to settlement in most cases. Approximately 90 per cent of tax disputes are settled before a notice of appeal is filed at the Tax Court of Canada.<sup>22</sup> Most of the remaining tax disputes are settled in the litigation stage but before trial. There are different legal mechanisms for concluding tax settlement agreements before and after a notice of appeal has been filed, which historically have had different consequences for how strictly the parties

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(FCA) [*Harris*], discussed below. Note that the Minister also does not have the power to assess other than in accordance with the *ETA*, *supra* note 3 as discussed below in *CIBC World Markets, 2012*, *supra* note 3.

17. *Harris*, *supra* note 16.

18. *Inland Revenue Comrs v National Federation of Self-Employed and Small Businesses Ltd*, [1981] 2 All ER 93 at 98 (HL (Eng)) [*Inland Revenue*], cited in *Harris*, *supra* note 16 at para 34.

19. *Inland Revenue*, *supra* note 18 at 101, cited in *Harris*, *supra* note 16 at para 35.

20. *Ludmer*, *supra* note 16.

21. *Ibid* at 17, cited in *Harris*, *supra* note 16 at para 36.

22. Sandler & Campbell, *supra* note 8 at 764.

must adhere to legal principles in order for the settlement agreement to be recognized by the courts and bind either or both parties. The courts' apparent inconsistent treatment of settlement agreements as valid and binding has been raised as grounds for amending tax statutes to permit compromise settlements. However, as will be shown below, it is possible to reconcile the jurisprudence, and fairly simple to design a principled settlement agreement so that it is symmetrically enforceable against both the taxpayer and the Minister.

a. *Binding on the taxpayer: Waiver of the right to objection or appeal*

It appears that a settlement agreement, even if unprincipled, will be binding on a taxpayer if the taxpayer has waived their rights of objection or appeal in writing.<sup>23</sup> There is a statutory basis for prohibiting objection or appeal after waiver by the taxpayer independent of whether the terms of the waiver-as-settlement agreement make it *ultra vires* the Minister.<sup>24</sup> Taxpayers can ensure that the settlement terms make the waiver conditional on the Minister assessing in accordance with the terms of the settlement agreement, as the Minister will not necessarily include such a term in its standard form waiver.<sup>25</sup> In the absence of such a term, it would appear that the waiver could still be binding on the taxpayer, and would prevent the taxpayer from objecting to a new assessment or appealing, even if the Minister did not assess in accordance with the terms of a compromise settlement.<sup>26</sup>

b. *Binding on the Minister and the taxpayer: Consent to judgment*

Once at the Tax Court of Canada appeals stage, settlements can be effected by filing a joint consent to judgment, containing the settlement terms.<sup>27</sup> If the judge finds the settlement acceptable, judgment will be issued accordingly, and will be binding on both parties.<sup>28</sup> However, the courts do not have the authority to issue judgment on a settlement, where the judgment would not be one that the court itself could have granted after

23. Often, a settlement agreement at the audit or appeal stage is drafted as a "waiver to the right of objection or appeal" and the terms the Minister has agreed to in exchange for the waiver are included.

24. *ITA*, *supra* note 3, ss 165(1.2), 169(2.2).

25. See Bruce Russell, "Waiving Objection/Appeal Rights: Art of the Deal" (2006) 3:6 *Tax Hyperion*. Note there is new case law, discussed below, that supports the notion that a clause making a waiver conditional on the Minister fulfilling her obligations under the settlement agreement would be binding (i.e., if the Minister did not fulfill the terms of the settlement, the taxpayer should have the right to appeal the resulting reassessments).

26. Nothing in the *ITA*, *supra* note 3, ss 165(1.2) or 169(2.2) make a waiver conditional on actions of the Minister.

27. *Tax Court of Canada Rules (General Procedure)*, SOR/90-688a, r 170 [*TCC Rules*].

28. Colin Campbell, *Administration of Income Tax*, 2011 (Toronto: Carswell, 2011) at 566.

hearing the appeal.<sup>29</sup> In other words, the Minister cannot be ordered by the court to assess other than in accordance with the terms of the *ITA*.<sup>30</sup> In order to give effect to a compromise settlement not otherwise in accordance with the terms of the *ITA*, parties will often agree to some set of facts, to which the correct application of the law results in a compromise amount of tax, interest and penalties.<sup>31</sup> The court will generally accept these principled settlements in issuing judgment on consent.<sup>32</sup>

*c. Bound depending on the terms: Settlement “for the purpose of disposing of an appeal”*

The taxpayer can also conclude a private settlement agreement with the Minister after a notice of appeal has been filed by agreeing to file a Notice of Discontinuance with the Tax Court upon issuance of a reassessment that is in accordance with the terms of the settlement. Proceedings on the matter would be stayed pending settlement, and the settlement agreement in such a case would likely also contain a waiver of the right to object or appeal the new reassessment.

Settlements “for the purpose of disposing of an appeal” under section 169(3) of the *ITA* allow the parties to settle privately, without a judgment being issued.<sup>33</sup> The wording of section 169(3) allows the Minister to reassess years that would otherwise be statute-barred, with the consent of the taxpayer and for the purposes of settling an appeal. These settlements may contain “unprincipled” or “compromise” solutions to a tax dispute, and in such cases the settlements will not be binding on both parties.<sup>34</sup> In some cases, a section 169(3) settlement will go so far as to contain a clause that confirms the parties’ understanding that the appellant has an unconditional right to a hearing at the Tax Court of Canada. While such settlements are not ideal from the perspective of upholding the rule of law in resolving tax disputes, they are an answer to the objection raised by proponents of compromise settlements that it is impossible to settle all-or-nothing, single issue tax disputes under the current regime. Parties can be creative with settlements not submitted to the court for consent to judgment. For example, parties could agree that an amount the Minister

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29. *Galway v MNR*, [1974] 1 FC 593 (FCA) at 595 [*Galway I*]. Note that there is more than one FCA *Galway* decision on consent to judgment in 1974. These references are to the April 22nd case. The June 6th case is discussed under the “Galway” heading, below.

30. *Galway I*, *supra* note 29 at 596.

31. Campbell, *supra* note 28 at 566. See also Ed Kroft, “Settlement Strategies in Tax Disputes” in Canadian Tax Foundation, 2001 *Prairie Provinces Tax Conference Report* (Toronto: CTF, 2001) 5:1.

32. Campbell, *supra* note 28 at 566 [Kroft, “Settlement Strategies”].

33. *Ibid.*

34. See *Consoltex*, *supra* note 4, explained below.

has assessed as interest income will be characterized as active business income for the purposes of calculating corporate tax payable. In a residency dispute, the Minister could agree to treat the taxpayer as a non-resident in some years but not in others. As long as a reasonable interpretation of the facts supports divisions along these lines, such settlements appear unproblematic. If the recharacterization is a fiction—as would likely be the case in recharacterizing interest income as active business income—then the resulting settlement may be as problematic as a compromise settlement from the perspective of ensuring the rule of law in taxation is upheld. These kinds of settlements remain confidential unless one party reneges and the settlement agreement ends up before the Tax Court. It is therefore impossible to gauge how often the principled approach to settlement is ignored in pre-trial settlements. Practitioners acknowledge that, in practice, limiting tax settlements to terms that have a principled basis in law is not a significant barrier to settlement.<sup>35</sup> It is a rare tax dispute that involves a single transaction in a single taxation year that can only be characterized as, e.g., on account of income or capital, and on which no horse trading can be done, e.g., expense deductibility. The possibility of settlement is limited only by the creativity of the parties, though in many cases it may be a matter of opinion whether the interpretation of the facts resulting in a settlement according with the law is reasonable. However, the fact that compromise settlements might currently be concluded under the guise of principle is not a reason to expand ministerial discretion so that compromise settlements will be enforceable in court. If anything, such expansion would exacerbate an existing legitimacy problem within Canada's system of tax administration and dispute resolution.

## 2. *Jurisprudence: Both the taxpayer and the Minister are bound by principled settlements*

The complexity and apparent contradictions in the case law on tax settlements are often offered up as a reason for legislative reform of the Minister's authority to settle. Unresolved issues in the case law have also been offered up as potential sources of future unfairness to taxpayers. This part of the paper will review the jurisprudence criticized by proponents of compromise settlement and demonstrate that it is possible to reconcile the case law. Further, it will demonstrate that the unresolved issues identified have either been resolved since they were raised, or would be possible to resolve by referring to new jurisprudence in a manner that does no injustice to taxpayers under the current principled approach.

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35. Pooja Samtani & Justin Kutyan, "Special Report: Tax Litigation Demystified" (2011) 59:3 Can Tax J 527 at 534. See also Kroft, "Settlement Strategies," *supra* note 31.

a. *Reconciling Smerchanski, Galway 2 and Cohen*

*Smerchanski v. MNR*<sup>36</sup> is a foundational case on the juridical enforcement of settlements. Laskin C.J., for the Supreme Court of Canada, bound the taxpayers where the rights to object and appeal had been waived. In that case, the taxpayers had admitted to tax evasion and agreed to pay the tax, interest and penalties flowing from the Minister's assessment of their previously unreported income. They then sought to appeal the assessments despite having waived their right to do so. Laskin C.J. said the threat of prosecution did not vitiate the waivers, as prosecution is always a threat where taxpayers make false or misleading statements in a tax return (as had been the case in *Smerchanski*). The *ITA* has since been amended to codify the principle in *Smerchanski*, namely that taxpayers are bound by their agreements to waive their rights to object and appeal on particular issues.<sup>37</sup>

At first glance, *Smerchanski* appears to be inconsistent with later decisions of the Federal Court of Appeal,<sup>38</sup> to the extent that Laskin C.J. suggested, “[t]here is no doubt of the enforceability of compromise agreements... absent vitiating circumstances.”<sup>39</sup> This would appear to bind taxpayers to compromise settlements, except that “vitiating circumstances” can be interpreted to mean circumstances where the Minister has no basis in law for assessing taxpayers in accordance with a compromise settlement. As was later pointed out in *1390758 Ontario Corp. v. R.*, nothing in *Smerchanski* suggested that the assessments flowing from the settlement agreement did not accord with an interpretation of the facts in accordance with the law.<sup>40</sup>

In *Galway 2*, the Federal Court of Appeal ruled that it could not grant an application for consent to judgment where the parties consented to a compromise settlement.<sup>41</sup> The amount in question was either fully taxable, or not taxable at all, depending on whether it was characterized as business income or as a gift. The Minister did not have discretion to tax only part of an amount in dispute, so the court could not rule that it should do so. The Court in *Galway 2* stated that it had doubted its jurisdiction to grant

36. *Smerchanski v MNR*, [1977] 2 SCR 23 [*Smerchanski*].

37. *ITA*, *supra* note 3, s 169(2.2) disallows appeal where the right of objection or appeal on a particular issue has been waived by the taxpayer in writing. Section 165(1.2) disallows objection where the right of objection on a particular issue has been waived by the taxpayer in writing.

38. *1390758 Ontario Corp v R*, 2010 TCC 572 at para 36, 2010 DTC 1385 [*1390758*] has also been cited in support of the proposition that settlements on the basis of agreed facts are binding (see, e.g., *CIBC World Markets*, 2012, *supra* note 3 at para 24).

39. *Smerchanski*, *supra* note 36 at 31.

40. *1390758*, *supra* note 38.

41. *Galway 2*, *supra* note 6.

an application for consent to judgment where, “the proposed judgment appeared to be intended to implement a compromise settlement rather than to implement an agreement between the parties as to how the assessment should have been made by application of the law to the true facts.”<sup>42</sup> The settlement agreement in *Galway 2* appeared particularly arbitrary since the Minister had agreed to assess the taxpayer for \$100,000 in respect of both interest and penalties. There was nothing to suggest that the parties had turned their minds to a correct amount of tax assessed that would give rise to a sum of \$100,000 when interest was included, or what the legal basis for assessing that amount of tax would be. It was clear that the parties had simply split the difference. The court’s discomfort with issuing a consent to judgment on an apparently arbitrary lump sum of tax and interest is palpable:

[I]n the circumstances of this case...the appropriate judgment would be a judgment that sets the judgment of the Trial Division aside and refers the assessment back for re-assessment on the basis of the fact agreed upon without attempting to determine the amount of tax or interest payable.<sup>43</sup>

Such a lump-sum settlement could have been reached on the basis of litigation risk, and in that sense would not have been arbitrary. However, the court found that the correct criterion for an enforceable tax settlement was whether it was based on an “application of the law to the true facts.”<sup>44</sup> However as indicated in the block quote above, *Galway 2* allows the parties flexibility to agree to what the true facts are. *Galway 2* is still the authoritative case on the non-binding nature of compromise settlement agreements.<sup>45</sup>

The Federal Court of Appeal also refused to enforce a settlement agreement against the Minister in *Cohen v. R.*<sup>46</sup> The taxpayer argued that the Minister could not treat gains on the sale of property as income, because the Minister had agreed to treat them as capital gains. In exchange, the taxpayer had agreed not to object to the assessment of similar gains as income in other years. The Federal Court of Appeal affirmed the trial judge’s holding that the Minister could not assess an amount implementing a compromise settlement, and added that such an agreement was “illegal,” and could not bind the Minister.<sup>47</sup>

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42. *Ibid* at 602.

43. *Ibid* at 603.

44. *Ibid* at 602.

45. As cited in, e.g., *CIBC World Markets, 2012*, *supra* note 3.

46. *Cohen v R* (1980), 80 DTC 6250 (FCA) [*Cohen*].

47. *Ibid* at 6251.

At first glance, the result in *Cohen* appears more troubling than that in *Galway 2*. It seems overly inflexible to find a settlement illegal where it divides up similar transactions in different years for different treatment—*if* it can be shown that some facts support the different characterizations. There was no suggestion in *Cohen* that the parties had identified any such supporting facts. The characterization of amounts as on account of sale of capital property, or as on account of business, is one of the most litigated issues in tax law. The law with respect to these so-called trading cases is not controversial; it is the facts that lead to controversy and to litigation. The former Chief Justice of the Tax Court, Donald Bowman, criticized *Cohen* for declaring that a common method of settling trading cases, to agree that some amounts will be on income account and others on capital account, is illegal.<sup>48</sup> It seems that *Cohen* should not preclude the settlement of future trading cases where the settlement divides up transactions according to factually supportable categories of capital and income. For example, it is possible that some early transactions were dispositions of investment properties (and therefore capital in nature) and later ones were “in the nature of trade” since the taxpayer’s intent and level of sophistication changed.<sup>49</sup>

*Consoltex Inc. v. Canada* dealt with a settlement agreement in which the taxpayer did not submit a waiver of its right to appeal.<sup>50</sup> On that basis, Bowman C.J. (Tax Court, as he then was) distinguished the facts in *Consoltex* from those in *Smerchanski*, where the Supreme Court had bound the taxpayers to their agreement to waive rights of appeal. Chief Justice Bowman ruled that unprincipled settlements which would not be binding on the Crown could not also be binding on a taxpayer:

It is unconscionable enough that the Minister should be able to renege on settlements that he or she has made. It would be doubly indefensible that a taxpayer should be unilaterally bound to honour agreements that the Minister is free to repudiate.<sup>51</sup>

He could not overrule the decisions of the Federal Court of Appeal concluding that compromise settlements are not binding on the Crown; however, he could rule that neither should those settlements be binding on taxpayers. This was not the ideal result, but it was the “least unacceptable”

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48. *Consoltex*, *supra* note 4 at 731.

49. See *ITA*, *supra* note 3, s 248 “business,” and, e.g., the foundational cases *MNR v Taylor*, [1956–60] Ex CR 3 and *Regal Heights Ltd v MNR*, [1960] SCR 902.

50. *Consoltex*, *supra* note 4.

51. *Ibid* at 732.

result.<sup>52</sup> However, the result in *Consoltex*, finding the taxpayer was not unilaterally bound by compromise settlement, may be limited to situations where the taxpayer has not waived the rights to objection and appeal. (Recall that the result in *Smerchanski*, that taxpayers are bound by their waivers, was reconciled with *Galway 2* and *Cohen* on the basis that the assessments flowing from the *Smerchanski* settlement had a principled basis in law—there was no unprincipled compromise to which neither party could be bound. Absent new statutory provisions that unconditionally bind taxpayers to their waivers, an illegal compromise settlement might also vitiate waivers to the rights of objection and appeal.) The new statutory provisions do not place conditions on the binding effect of waivers, thus taxpayers may still be unilaterally bound to a compromise settlement where a waiver has been submitted.<sup>53</sup> New case law, discussed below, suggests that it is possible to make the waiver of the taxpayer's rights to objection and appeal conditional on the Minister fulfilling her obligations under the settlement agreement.

*1390758* further reconciles the body of case law on tax settlements.<sup>54</sup> In *1390758*, the Minister brought a motion to quash a corporate taxpayer's appeals, on the basis that the reassessments under appeal were the result of a settlement agreement. The motion was allowed, and the appeals quashed, on the basis that the reassessments made pursuant to the settlement agreement were in accordance with the facts and law. Justice Bowie made comments in that case that, contrary to Hogg, Magee and Li,<sup>55</sup> the *Smerchanski* and *Cohen* cases are reconcilable. In *Smerchanski*, as in *1390758*, "there was no suggestion that the assessments were anything other than the result that flowed from the application of the law to the facts that were revealed by the audit."<sup>56</sup> In other words, *Smerchanski* is distinguishable from other cases that found compromise settlements to be non-binding, since *Smerchanski* did not involve a compromise settlement. Thus the Tax Court in *1390758* found grounds to enforce a settlement agreement with a principled basis, a result further endorsed in *Huppe v. R.*<sup>57</sup> In *Huppe*, the taxpayer brought a motion to enforce a settlement agreement. The

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52. *Ibid.*

53. See, *ITA*, *supra* note 3, ss 165(1.2), 169(2.2) discussed *supra*. Taxpayers should be able to deal with this problem by including a clause in the settlement agreement (often submitted in the form of a waiver) that the waiver is conditional on assessment in accordance with the terms of the agreement.

54. *1390758*, *supra* note 38.

55. Peter W Hogg, Joanne E Magee & Jinyan Li, *Principles of Canadian Income Tax Law*, 8th ed (Toronto: Carswell, 2013) at 569-570. *Consoltex*, *supra* note 4 cited an earlier edition of the text but the relevant criticism remains in the 8th edition.

56. *1390758*, *supra* note 38 at para 39.

57. *Huppe v R*, 2010 TCC 644, 2011 DTC 1042 [*Huppe*].

Minister argued that the motion should be summarily dismissed, as the Tax Court did not have jurisdiction to enforce a settlement, even if such a settlement agreement were established. Justice Webb ruled that the Tax Court of Canada does have the jurisdiction to enforce a settlement under section 171(1) of the *ITA*, which grants the Tax Court the power to vacate or vary an assessment, or to refer an assessment back to the Minister for reconsideration and reassessment. Taken together, *1390758* and *Huppe* demonstrate that tax settlements can indeed be enforced by the courts. They bind both the taxpayer and the Minister where the settlement has a principled basis in law. Where the settlement has no principled basis in law, it is unenforceable against either party per *Consoltex*. These cases should put to rest the criticism raised by proponents of compromise settlements that the requirement for a principled basis in law results in unfairness to taxpayers, since it was previously unclear whether taxpayers would have recourse to the courts to enforce principled settlements with the Minister.<sup>58</sup>

The only possible unfairness might result if a court finds a compromise settlement binding against the taxpayer only, on the basis that a statutory waiver of the right to objection and appeal has been filed and there is no clause that invalidates the waiver in case the settlement can be found *ultra vires* the Minister. It has been speculated that the unconditional nature of the statutory language on waivers would prevent taxpayers from appealing assessments issued on the basis of an illegal compromise settlement.<sup>59</sup> *Consoltex*, which found that compromise settlements are not enforceable against either party, could be distinguished since it did not involve waivers. Such a result might be prevented by relying on Bowie J.'s comments in *1390758* suggesting that *Smerchanski* (where the taxpayers had submitted waivers) might have had a different result had the settlement agreement been unprincipled. However, the ratio in *Smerchanski* has been enshrined in statutory provisions that appear to make the waiver of the right to objection and appeal unconditional. It would seem unjust to use a waiver to prevent a taxpayer from objecting to, and appealing, an assessment where it flowed from an unprincipled settlement. The Minister does not have the authority to settle or assess without a basis in law in the first place. The problem on these facts arises because of the failure of the statutory provisions on

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58. This resolves the first of two outstanding issues raised by Sandler & Campbell, *supra* note 8 at 775, as not yet decided by the courts. That is, the authors were concerned that taxpayers might not be able to enforce principled settlement agreements against the Minister.

59. This is raised as the second of two outstanding issues with the enforceability of settlement agreements in Sandler & Campbell, *supra* note 8 at 775. For reasons discussed *infra*, it should not be a difficult issue for the courts to resolve so that taxpayers are not bound by waivers that are part of a settlement agreement per the *ITA*, *supra* note 3, s 169(3). The courts appear to have interpreted waivers according to conditions in the settlement agreement itself.

waiver to stipulate exceptions by acknowledging that waivers should be void where they are issued as part of an illegal compromise settlement. This is not a problem with the principled approach to settlement itself. Fortunately, if this issue does come before the courts, it should be fairly simple to find authority to resolve it in favour of the taxpayer. The courts have used language that suggests waivers are not absolute. In *Burg Properties Ltd. v. Canada*,<sup>60</sup> the Federal Court of Appeal used language suggesting that waivers containing a clause that made them conditional on assessment in accordance with settlement were valid because the Minister had complied with the condition to the waiver, and assessed the taxpayer in accordance with the settlement agreement.

The appeals were quashed on the basis that the appellant had entered into a settlement agreement with the Canada Revenue Agency in which it was agreed that if the Minister of National Revenue reassessed the appellant in accordance with the terms of the settlement agreement, the appellant waived its rights of objection and appeal. The Tax Court of Canada found that the Minister reassessed the appellant in accordance with the terms of the settlement agreement *so that* the appellant had waived his rights of objection and appeal.<sup>61</sup>

This language suggests a causal relationship between the Minister honouring the terms of her agreement and the binding of the taxpayer to its waiver. If a waiver can be made conditional on other terms of a settlement agreement, waivers should not be considered absolute, despite statutory language that appears to make them so. If parties can agree to conditions on a taxpayer's waiver, it should also be possible to disregard a waiver where the taxpayer wishes to appeal an assessment that is outside the Minister's discretion. Thus the result in *Consoltex*, that taxpayers are not bound by compromise settlements, should be extended to situations where the taxpayer has signed a waiver of the rights to objection and appeal.

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60. *Burg Properties Ltd v Canada*, 2014 FCA 154, 2014 DTC 5110 [*Burg Properties*], leave to appeal to SCC refused, 36046 (18 December 2014). Note that this case involved a waiver of the rights to objection and appeal under the *ETA*, *supra* note 3. However, the language is similarly absolute in the relevant provisions of that statute. See *ETA*, *supra* note 3, ss 301.1(1.6), 306.1(2).

61. *Burg Properties*, *supra* note 60 at para 2 [emphasis added].

b. CIBC World Markets: *Compromise settlement offers have no impact on costs*

One more significant development in the jurisprudence is worth mentioning, if only to point out that it is consistent with previous case law, and that it supports the integrity of the justice system in resolving tax disputes rather than resulting in an injustice to parties settling a dispute. *CIBC World Markets Inc. v. Canada* deals with the implications of the principled approach to settlement for cost awards.<sup>62</sup> Both the Tax Court of Canada and the Federal Court of Appeal have rules allowing higher cost awards to parties who have offered to settle under specific circumstances, if the result in the final judgment is more favourable to the party who offered to settle.<sup>63</sup> The policy behind these rules is to encourage settlement by allowing substantially higher cost awards to a party who has offered to settle, where it appears the unsuccessful litigant ought to have accepted the settlement offer instead of pursuing the dispute to judgment.

After a successful appeal of a GST matter at the Federal Court of Appeal,<sup>64</sup> CIBC World Markets made a motion for a higher cost award running from the date of its settlement offer.<sup>65</sup> The settlement, which offered to allow CIBC to claim 90 per cent of the input tax credits in issue, was filed prior to the taxpayer's unsuccessful Tax Court appeal.<sup>66</sup> The Minister argued that the settlement offer should not affect costs, as it was a compromise settlement and the Minister did not have the discretion to accept it.

The Federal Court of Appeal dismissed CIBC's motion on costs, ruling that the original settlement offer could not affect costs on appeal. The first flaw in CIBC's request had nothing to do with compromise settlements: CIBC had not reasserted the settlement offer prior to the appeal at the Federal Court of Appeal and therefore an increased cost award would not be granted at the appellate level. As for costs at the Tax Court, the Federal Court of Appeal accepted the Minister's argument that it was under a "legal disability" that prevented it from accepting the compromise settlement offer.<sup>67</sup> Following the reasoning in the earlier Federal Court of

62. *CIBC World Markets*, 2012, *supra* note 3.

63. *TCC Rules*, *supra* note 27, r 147(3)(d), 147(3.1)–(3.7); *Federal Courts Rules* SOR/98-106, r 400(3)(e).

64. *CIBC World Markets Inc v Canada*, 2011 FCA 270, [2013] 3 FCR 3 [*CIBC World Markets*, 2011].

65. *CIBC World Markets*, 2012, *supra* note 3.

66. *CIBC World Markets Inc v R*, 2010 TCC 460, 2010 GTC 94.

67. *CIBC World Markets*, 2012, *supra* note 3 at para 16.

Appeal decisions in *Galway*<sup>68</sup> and *Cohen*,<sup>69</sup> the court found that since there was no basis in fact or in law for the Minister to accept the 90 per cent settlement, the offer should be disregarded for the purpose of awarding costs. The court reasoned it is an implicit pre-condition in the rules on considering settlement offers in cost awards that the recipient of the offer must be legally able to accept the offer. No adverse cost consequences should flow from failure to accept an offer which is outside the Minister's discretion to accept. The Federal Court of Appeal did not deal with the question of whether a compromise settlement offer issued by the Minister could result in a higher cost award against the taxpayer if the Minister prevailed on appeal, since that was not the issue before the court. However, the same logic should preclude an increased cost award for the Minister: the Minister has no authority to offer to assess without a basis in law for the assessment—therefore, such an offer should also be disregarded for the purposes of granting costs.

*CIBC World Markets, 2012* has been criticized as being at odds with the policy behind cost rules encouraging settlement.<sup>70</sup> Critics refer to the reality that many tax disputes are settled before trial, and assume many of these pre-trial settlements are unprincipled and would be discouraged by an inability to claim increased cost awards for tendering a compromise offer.<sup>71</sup> The court in *CIBC World Markets, 2012* said that the input tax credits (ITCs) in dispute could not be the subject of a 90 per cent compromise settlement on the basis of facts and law because the quantum of credits was not in dispute. The issue was a rare “all-or-nothing question of statutory interpretation”<sup>72</sup> on the ability of the taxpayer to change its method for computing input tax credits to increase its claim. Had the dispute been a disagreement about the facts surrounding the input tax credits claimed, as many disputes over ITCs are, it would have been possible to interpret the facts in such a way that the ITCs could have been divided for the purposes of settling the dispute. This does not mean that all litigation involving all-or-nothing disputes wastes judicial resources. Where, as in *CIBC World Markets, 2012*, the courts can settle the law on a contested point of statutory interpretation, there is value in pursuing the dispute to judgment.

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68. *Galway 2*, *supra* note 6.

69. *Cohen*, *supra* note 46. The Federal Court of Appeal also referred to *Harris*, *supra* note 16, a more recent decision affirming the Federal Court of Appeal's position on ministerial discretion in *Galway 2* and *Cohen*.

70. *CIBC World Markets, 2012*, *supra* note 3.

71. See, e.g., Jacques Plante, “Settlement Offers: *CIBC World Markets Inc. v. Her Majesty The Queen*” (April 2012) CCH Tax & Accounting eMonthly, online: <[www.cch.ca/newsletters/TaxAccounting/April2012/Index.htm](http://www.cch.ca/newsletters/TaxAccounting/April2012/Index.htm)>.

72. *CIBC World Markets, 2012*, *supra* note 3 at para 19.

Far from being rigid and doctrinaire in its approach to tax settlements in *CIBC World Markets, 2012*, the Federal Court of Appeal implicitly acknowledges that settlement would have been possible had the dispute been a factual one over the quantum of eligible credits.<sup>73</sup> Justice Stratas, writing for the Court, contrasts settlements that are made “solely on the basis of compromise” with those that “[follow] the facts and the law as the Minister views them *or might reasonably defend them*.”<sup>74</sup> This standard of principled-basis settlement is not insurmountable: it requires a position on the application of law to facts that is reasonably defensible. This supports comments made by practitioners prior to *CIBC World Markets, 2012* that, “some would suggest that if the litigants are keen on settling the case, it is always possible to find a principled basis,”<sup>75</sup> with the caveat that disputes about the correct interpretation of the law often cannot be—and perhaps should not be—settled prior to judgment.

c. *Assessing the jurisprudence: Not as rigid as critics suggest*

It may at first appear as though courts have bound the authority of the Minister on the basis of legal formalism: only the strictest interpretation of the word “shall” in provisions prescribing the Minister’s duties would prevent the Minister from reaching compromise settlements outside the letter of the law. This formalistic approach has been criticized on pragmatic grounds: that it would be more practical for the courts to apply a looser interpretation of the Minister’s obligations and enforce compromise settlements. However, the courts’ apparently formalist interpretations can also be viewed pragmatically. The Federal Court of Appeal in *Galway 2, Cohen*, and *CIBC World Markets, 2012* is not merely upholding strict wording for the sake of applying (and not creating) law. Underlying these judgments, which appear to rest solely on strict interpretation, is concern that the Minister not exercise discretion in a manner that could be perceived by the public as arbitrary. Both the \$100,000 settlement for all of tax, interest and penalties in *Galway 2* and the 90 per cent settlement offer in *CIBC World Markets, 2012* could be viewed critically by the public as arbitrary reductions of the tax obligations for litigious taxpayers—especially absent any reasons justifying these settlement terms according to fact and law. A broader concern is the vast number of tax settlements that do not reach public scrutiny through the court system. Requiring those settlements to have a principled basis in law in order to be recognized by the courts at least forces the Minister to try to get to some justifiable

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73. *Ibid.*

74. *Ibid.* at para 25 [emphasis added].

75. Samtani & Kutyan, *supra* note 35 at 534. See also Kroft, “Settlement Strategies,” *supra* note 31.

amount of tax owing—i.e., these cases reflect discomfort with the idea that the Minister could arbitrarily split the difference as in *Galway 2* and as in the settlement offer at issue in *CIBC World Markets, 2012*.

Perhaps the most scathing criticism of the current state of the law resulting from the Federal Court of Appeal decisions in *Galway 2* and *Cohen* appears in Hogg, Magee and Li's *Principles of Canadian Income Tax Law*:

The CRA has limited resources and it is not realistic to require the Minister to insist on every last legal point, and to litigate every dispute to the bitter end. Most disputes about tax are simply disputes about money which are inherently capable of resolution by compromise. Presumably, the Minister would agree to a compromise settlement only on the basis that it offered a better net recovery than would probably be achieved by continuance of the litigation. It seems foolish to require the Minister to incur the unnecessary costs of avoidable litigation in the name of an abstract statutory duty to apply the law.<sup>76</sup>

With respect, the rigidity described by Hogg, Magee and Li, requiring the Minister to litigate every last dispute “to the bitter end,” would only be the result of the strictest possible interpretation of *Cohen*.<sup>77</sup> In practice, requiring a principled basis for tax settlements does not require the Minister to litigate every last tax dispute, without regard for the costs of doing so. It simply requires the Minister and the taxpayer to come to some reasoned agreement about the merits of facts leaning one way or another in the circumstances of the dispute. There is usually more than one issue, more than one category of receipt or loss, and more than one tax accounting period at issue in a tax dispute, and some agreement can be reached to divide amounts along any of those lines.

As for the remainder of the Hogg, Magee and Li quotation, tax disputes are not just about money. The equity of the tax system would be at stake if the Minister were permitted to settle cases on the basis of the best net recovery of costs, since such a system would reward particularly litigious taxpayers. The fact that the U.K., for example, administers its tax system this way does not mean it would benefit the Canadian system to adopt such an approach, or be consistent with maintaining the integrity of the Canadian system. There is some value in a check on ministerial discretion that requires the parties to settle on some amount of tax that is defensible

76. Hogg, Magee & Li, *supra* note 55 at 570. The newest edition has not incorporated *CIBC World Markets, 2012*, *supra* note 3, but that case does not deviate from the rigidity that Hogg, Magee & Li are criticizing.

77. Recall that *Cohen*, *supra* note 46 was criticized by former Chief Justice Bowman for its failure to recognize a common method of settling trading cases in *Consoltex*, *supra* note 4 at 731.

under the law, and there are additional administrative costs associated with allowing taxpayers to tender compromise settlement offers.<sup>78</sup>

The judiciary has articulated the law on principled-basis tax settlements, particularly in *CIBC World Markets, 2012*, so that it is flexible enough to allow settlement in most instances where facts, but not laws, are in dispute. However, calls are still being made for more research towards allowing compromise-basis tax settlements.<sup>79</sup> The remainder of this paper will deconstruct arguments in favour of extending Ministerial discretion to settle tax cases on a compromise basis, starting with the *Carter Report* and concluding that such extension is unnecessary and would be detrimental to the integrity of the Canadian tax system.

### III. *Back to the Carter Report: A selective criticism of ministerial discretion*

The Carter Commission recommended, in its 1966 Report, implementation of a U.S.-style tax settlement system allowing taxpayers to make offers in compromise to the Minister.<sup>80</sup> However, the recommendation appears in a single paragraph. Unlike many of the Report's most influential recommendations on changes to the substantive tax law, this paragraph appears with no analysis of potential problems with implementing such a system. It is sandwiched between one paragraph on uncollectible debts and one on the Commission's concern that taxes might be evaded by taxpayers leaving Canada. The entire recommendation is as follows:

We also recommend institution of the "offer of compromise" procedure, available to United States taxpayers, under which a taxpayer owing more than his net worth may institute proceedings requesting that a settlement be made for a lower amount. Any such settlement should be made public, being filed in a registry and available for inspection. Publicity would be a full safeguard against abuse of such a system. In our view the offer of compromise procedure should not be available to any taxpayer who had knowingly understated his income.<sup>81</sup>

78. See, e.g., the discussion of baseless offers-in-compromise being issued in the US in CNBC "Need Tax Debt Settlement? Avoid This Scam," CNBC (3 October 2008), online: <[www.cnbc.com/id/27009005/](http://www.cnbc.com/id/27009005/)>, cited in Carman R McNary, Paul Lynch & Anne-Marie Lévesque, "Tax Dispute Resolution: Is There a Better Way?" in Canadian Tax Foundation, *Report of Proceedings of the Sixty-Second Tax Conference* (Toronto: CTF, 2011) 14:1 at 14:7.

79. Most recently in Jackson, *supra* note 8.

80. *Carter Report*, *supra* note 7 at 149. Interestingly, the Carter Commission's recommendation to allow a US-style system of offers in compromise pre-dates the case law that is typically cited for the proposition that the Minister's discretion to settle is limited to settlement on a principled basis. See also Jackson, *supra* note 8. That chapter suggests that more research is required to implement the *Carter Report's* proposal on settlement.

81. *Carter Report*, *supra* note 7 at 149.

There are several problems with this recommendation that suggest that it should not be used as the basis for reforming today's system of tax administration, and that the members of the Carter Commission perhaps did not think through the consequences of such a program.<sup>82</sup> First, other mechanisms are available to taxpayers who cannot pay their full tax debt because of financial constraints, so an additional mechanism is redundant. For example, it is possible for taxpayers to obtain a discharge into bankruptcy that can relieve them of some or all of their tax obligation. Taxpayers also can negotiate a tax debt payment plan with the Minister if they cannot pay a tax debt in full immediately. It is not clear that additional ministerial discretion is required to deal with the insolvency of tax debtors. Second, this recommendation appears after a lengthy section in the immediately preceding chapter of the Report expressing concern over existing ministerial discretion to grant or deny advance tax rulings.<sup>83</sup>

1. *Problems with ministerial discretion: Advance ruling requests*

The Commission's conclusion on ministerial discretion to grant or deny advance rulings summarizes its concerns:

Ministerial discretion should be kept to a minimum in tax legislation; where it is employed, the taxpayer should have the right to require an advance ruling on stated facts, and a parliamentary committee each year should examine the manner in which the discretionary powers have been used and report on the continuing need for the discretion.<sup>84</sup>

Why is so much concern expressed over the Minister's power to grant or deny advance rulings, while none is expressed over granting the Minister additional discretion to grant or deny the proposed offers in compromise? The issues are similar. In an advance ruling request, a taxpayer requests an interpretation of the law as it applies to a proposed transaction that may or may not go forward depending on the Minister's agreement to grant tax treatment in accordance with the taxpayer's interpretation of the law. A great deal of tax is sometimes at stake in these advance ruling requests, and the Minister's exercise of discretion has been the subject of some scandal in the wake of an Auditor General's report on the rulings

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82. Note that the establishment of an offer of compromise procedure does not appear in the "Conclusions and Recommendations" section at the end of the relevant chapter: *ibid* at 157-159. The *Carter Report* is organized so that major recommendations appear in summary form at the end of each chapter; therefore, the absence of the offers of compromise procedure from that section is notable and suggests it was not a recommendation the Commission considered particularly important.

83. *Ibid* at 126-128; see also at 129-130.

84. *Ibid* at 130.

process.<sup>85</sup> Controversy over the Minister's exercise of discretion to settle tax debts in response to an offer in compromise could be expected to be as great as, if not greater than, the controversy over the discretion exercised in the granting of advance rulings. It appears that the members of the Commission simply did not turn their minds to the potential problems with the ministerial discretion which would have to be granted in order to implement the proposed system of U.S.-style offers in compromise.

The *Carter Report* pre-dates the foundational jurisprudence interpreting the scope of the Minister's discretion to administer tax legislation in the context of settling tax disputes. The Report did contain commentary on the judiciary's role in curbing inappropriate exercise of discretion, though in the context, again, of discretion in issuing advance rulings:

[I]n essence, the court has no power to intervene unless it can be shown that the Minister, in exercising his discretion, acted on erroneous legal principles, was influenced by irrelevant or improper considerations, or acted arbitrarily.

In view of the limited scope of the authority of the courts, they cannot be relied upon to provide the taxpayer with all the protection he requires against the dangers inherent in the exercise of ministerial discretion.<sup>86</sup>

The Carter Commission's concern here was protecting the rights of the individual taxpayer from the arbitrary exercise of ministerial discretion. Discretion that is exercised inconsistently, especially if it is non-transparent, risks inequitable outcomes for taxpayers. Looking at the equity of the tax system more broadly, this inconsistency could create problems for both horizontal and vertical equity. Similarly-situated taxpayers could be treated differently, thus violating horizontal equity. This was the concern in *Harris*,<sup>87</sup> where the Minister was sued by a concerned citizen for issuing, allegedly in bad faith, advance rulings to other taxpayers allowing a shift of taxable property out of Canada without triggering an immediate tax liability. The concern was that the favourable rulings, which had been issued privately, contradicted a general announcement the Minister had made indicating that similar transactions would be subject to deemed disposition rules, triggering an immediate tax liability. These rulings were the subject of an Auditor General's report that specifically criticized the Minister for issuing preferential private rulings that the public was not aware of, thus

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85. There is an extensive discussion of the controversy raised by one set of advance rulings in particular, which it was argued had been issued in bad faith since the Minister had allegedly granted preferential treatment in issuing the rulings, in *Harris*, *supra* note 16.

86. *Carter Report*, *supra* note 7 at 127.

87. *Harris*, *supra* note 16.

making tax benefits apparently available only to some taxpayers.<sup>88</sup> The Minister won the *Harris* case, with the Federal Court of Appeal finding no inappropriate exercise of discretion on the Minister's part. The *Carter Report* had anticipated, in the quotation above, the limited ability of the courts to address arbitrary exercises of ministerial discretion, though its concern with discretion had been for the individual taxpayer and not for the integrity of the tax system as a whole. The circumstances underpinning *Harris*, as described in the Auditor General's report on ministerial advance rulings, remain an example of the type of tax equity violation that can occur if the Minister's exercise of discretion is inconsistent or arbitrary. In the context of tax settlements in particular, horizontal equity could be violated where taxpayers are similarly situated but litigious taxpayers are able to persuade the Minister to offer more favourable settlement terms under an offer in compromise regime. There are no tax policy criteria that would justify lower tax burdens for litigious or aggressive taxpayers. Vertical equity could also be compromised where the Minister is granted discretion, since taxpayers with greater resources are better able to hire professionals who can advocate for more favourable settlement terms than could taxpayers of lesser means.

The *Carter Report* goes on to suggest that the problems with ministerial discretion in the advance rulings context could be allayed by requiring the Minister to subject its exercise of that discretion to public scrutiny. This would be achieved by reporting annually to Parliament.<sup>89</sup> But publicity may not be a complete safeguard in the advance rulings context, and perhaps even less so in the settlement context. Who, other than the taxpayer who is the subject of an advance ruling or tax settlement, would have standing in a court of law or the desire to challenge the Minister's exercise of discretion? *Harris*, at least at the Federal Court of Appeal level, suggests that concerned citizens would have standing to sue the Minister where a ruling was issued in bad faith to a third-party taxpayer.<sup>90</sup> Similarly, concerned citizens might be moved to challenge a tax settlement if it seemed to favour a particular taxpayer in a manner that brought the fairness of tax administration into question. However, the value of opening tax settlements up for public scrutiny would compete with the perceived importance of confidentiality in tax settlements. Taxpayers currently can avoid public scrutiny of a tax dispute with the Minister by settling before

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88. *Ibid* at para 13.

89. *Carter Report*, *supra* note 7 at 128.

90. *Harris*, *supra* note 16 at paras 64-66.

the matter goes before the Tax Court, so publicizing tax settlements might remove one of the pressures on taxpayers to settle before trial.

At the time of *Harris*, advance rulings were not all broadly available to the public and the profession as they are today. Since 1993, all advance rulings are released in severed form by the Minister under access to information legislation.<sup>91</sup> Prior to that time, the Minister published selected rulings only. Currently, advance rulings are released to private tax information services used by the tax profession, such as Taxnet Pro and CCH, but they are also broadly available to the public at sites like [taxinterpretations.com](http://taxinterpretations.com). This kind of publicity appears to be, in combination with the right of concerned citizens to sue the Minister per *Harris*, a complete safeguard to the arbitrary exercise of ministerial discretion in issuing advance rulings. The redacted advance ruling letters issued by the Minister have a broad readership among the tax profession, and any perceived inequity in the issuance of favourable rulings to some taxpayers but not others would be picked up on by tax professionals. Were the exercise of discretion particularly egregious, it would be blogged about or otherwise published by tax professionals and possibly the broader media.

Another public mechanism for relief from taxation is the remission order, though such orders are considered an extraordinary measure. Remission orders are granted at the Minister's discretion under the *Financial Administration Act*.<sup>92</sup> Where a remission order is granted it is published in Part II of the Canada Gazette, so in theory there is public oversight of this type of ministerial discretion. However, where remission orders are denied there is no public notice so public scrutiny is not possible unless the taxpayer either made the denial public or challenged the denial on judicial review. Still, the public nature of the remission order process, combined with the opportunity to bring an application for judicial review to Federal Court, constitute sufficient public and judicial oversight of the remission order process. Arbitrary exercise of ministerial discretion to grant remission orders is not a concern on par with the risk of arbitrary exercise of discretion were the Minister permitted to conclude confidential settlement agreements with taxpayers on a compromise basis. The requirement that tax settlements be concluded on a principled basis is an imperfect stand-in for the safeguard of public scrutiny that is barred by the public interest in protecting the confidentiality of tax settlements.

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91. See Canada Revenue Agency, "Public dissemination of rulings and interpretations" (Ottawa: CRA), online: <[archive-ca.com/page/4043025/2014-05-31/http://www.cra-arc.gc.ca/tx/txprfasnls/srves/dssmntn/menu-eng.html](http://archive-ca.com/page/4043025/2014-05-31/http://www.cra-arc.gc.ca/tx/txprfasnls/srves/dssmntn/menu-eng.html)>.

92. *Financial Administration Act*, RSC 1985, c F-11, s 23(2).

Publicity as a complete safeguard against the arbitrary exercise of ministerial discretion should not be extended to the settlement context without serious consideration of the competing value of taxpayer confidentiality. Publicizing tax settlements could expose taxpayers to having sensitive information revealed merely because they were audited and negotiated with audit officials prior to reassessment, e.g., by providing additional supporting information. Consideration would have to be given to when in the tax dispute resolution process a settlement agreement would be made public, and what information would be publicized. Taxpayer information is closely protected in our tax system, and can only be shared in specific circumstances permitted by statute.<sup>93</sup> That is why advance rulings, even though they are all made available to various publishers, are redacted to protect the identities of the taxpayers requesting the rulings. Tax settlements in the pre-litigation stage currently take place on a confidential basis, i.e., their terms are not made available to the public as advance rulings are.<sup>94</sup> Advance rulings do not invoke similar public policy considerations because they must be requested before a proposed transaction has taken place. Thus the decision to request or not request an advance ruling does not affect the administration of justice in the way that settlement offers do—by potentially reducing the number of tax disputes the courts must resolve. Moreover, publicity in the context of a remission order is not a serious concern in terms of protection of taxpayer information since, as in the case of advance ruling requests, taxpayers typically apply for or work with the Minister to obtain a remission order. Taxpayers are also, presumably, aware (or made aware) that successful requests for remission orders will result in publication of the order. If that publicity discourages requests for remission orders, it is less troublesome than if publicized settlement agreements remove the incentive to resolve disputes prior to litigation in order to protect taxpayer confidentiality.

The Supreme Court of Canada recently reaffirmed the importance of settlement privilege to the administration of justice in *Sable Offshore Energy Inc. v. Ameron International Corp.*:

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93. *ITA*, *supra* note 3, s 241. Some exceptions to the rule that taxpayer information must remain confidential are, e.g., to collect data for government statistics and to answer access to information requests without revealing taxpayers' identities.

94. Some or all terms of a settlement must be made public if the settlement takes the form of a consent to judgment in the Tax Court of Canada. That is, the parties can agree to settle a case that is already on the Tax Court docket and, assuming the settlement has a principled basis in law, a judge can issue judgment according to the terms of the settlement. Such a consent to judgment will become public since it takes the form of a decision of the Tax Court made on consent of the parties.

The justice system is on a constant quest for ameliorative strategies that reduce litigation's stubbornly endemic delays, expense and stress. In this evolving mission to confront barriers to access to justice, some strategies for resolving disputes have proven to be more enduringly successful than others. Of these, few can claim the tradition of success rightfully attributed to settlements.

The purpose of settlement privilege is to promote settlement. The privilege wraps a protective veil around the efforts parties make to settle their disputes by ensuring that communications made in the course of these negotiations are inadmissible.<sup>95</sup>

Given this clear direction from the Supreme Court that settlement negotiations, and the terms of settlements themselves, ought to remain privileged except where specific exceptions apply, it would be difficult to argue that information about individual tax settlements concluded by the Minister ought to be made public. However, *Sable Offshore* involved private parties, and there is less public interest at stake in the fairness of settlements between private parties. Canadian taxpayers do have a stake in the fairness and consistency of tax settlements that should be balanced against the objective of encouraging settlement prior to litigation. An alternative would be to release settlements in a redacted form, as advance ruling letters are, sufficient to protect taxpayers' identities. Where the issue is one that affects a group of taxpayers with separate appeals on substantially the same issues and facts (for example, the Native Leasing Services<sup>96</sup> cases and charity tax shelters) the terms of settlement could be leveraged by either the Minister or other taxpayers to further their cause in future disputes. The Minister might be less willing to settle on issues common to many taxpayers where others might try to use the settlement as precedent for similar treatment. Although it involved private parties, this concern was more or less the one in *Sable Offshore*, quoted above: the Supreme Court declined to have the settlement figures agreed upon by some litigants disclosed to other litigants who had not settled. Settlement privilege, as a policy in the public interest, was upheld lest future settlements be discouraged by the possibility that settlement terms could become public. Similarly, in the tax context, publicizing settlement terms could foreseeably hinder tax dispute resolution. The goal of expanding ministerial discretion to conclude compromise settlements would be to

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95. *Sable Offshore Energy Inc v Ameron International Corp*, 2013 SCC 37 at paras 1-2, [2013] 2 SCR 623 [*Sable Offshore*].

96. See, e.g., *Horn v Canada*, 2008 FCA 352, 2008 DTC 6743. The issues in that case are common to hundreds of taxpayers who are litigating their disputes as separate appeals.

facilitate settlement, and publicizing those settlements to prevent arbitrary exercise of ministerial discretion could frustrate that purpose.

Could arbitrary exercise of ministerial discretion be curbed if aggregated data about amounts settled on in an offer in compromise process were made public? For example, there could be an annual report of the total tax ceded by the Minister through settlement, and the average amount of tax ceded in each case. This sort of data is available through access to information requests for taxpayer relief from interest and penalties, which the Minister has statutory authority to waive.<sup>97</sup> The privacy of taxpayers, and settlement privilege, would be protected if data could be gathered and released on a group basis. However, releasing total and average tax settlement information would make particular instances of inconsistent exercise of ministerial discretion impossible to identify. This can be demonstrated by an attempt to interpret taxpayer relief data.

## 2. *More problems with ministerial discretion: Taxpayer relief*

The taxpayer relief provisions (formerly the “Fairness Package” at the time of their introduction in 1991) are best known for permitting the Minister to waive or cancel interest or penalties.<sup>98</sup> They do not permit the Minister to compromise on an amount of tax assessed.

### a. *Taxpayer relief and voluntary disclosures*

The taxpayer relief provisions provide the authority for the voluntary disclosures program. A taxpayer who voluntarily discloses unreported income can reach an agreement to pay the tax owing on the unreported income and receive a waiver of penalties and partial interest relief.<sup>99</sup> Granting the Minister discretion to waive interest (and, to a lesser extent, penalties) is subject to similar equity, transparency, and public confidence objections as compromise-basis settlement. Whether penalties should be assessed or waived is a matter of what deterrents to non-compliance (and incentives for compliance) should apply to best administer and enforce a self-reporting tax system. To the extent that interest on outstanding tax liabilities represents the time value of money, waiving interest on a tax

97. *ITA*, *supra* note 3, s 220(3.1).

98. The term “taxpayer relief” also encompasses extensions of time to file or amend certain elections, obtain refunds, reassessments or redeterminations outside the normal three-year assessment period. This paper will refer to “taxpayer relief” only with respect to relief from interest and penalties. See *ibid.*

99. Time constraints on this relief are imposed either by statute or by the CRA’s administrative policy. See Canada Revenue Agency, Income Tax Information Circular IC00-1R4, “Voluntary Disclosures Program” (9 April 2014) at para 16, online: CRA <[www.cra-arc.gc.ca/E/pub/tp/ic00-1r4/ic00-1r4-e.html](http://www.cra-arc.gc.ca/E/pub/tp/ic00-1r4/ic00-1r4-e.html)>.

liability is equivalent to waiving part of the tax.<sup>100</sup> The federal government justifies this relief on the grounds that voluntary disclosures bring in tax revenue from unreported income that otherwise might have remained undisclosed. Sacrificing penalties and some of the tax debt in the form of interest relief is thought to be consistent with administrability, since the government presumably collects more tax revenue overall as a result of taxpayer disclosure of previously unreported income. Taxpayers are still liable for tax assessed on the previously unreported income, and it is on that amount the Minister cannot compromise.

It is also thought that strict enforcement of tax, interest, and penalties might put executors and beneficiaries of the estate of a deceased individual with unreported income in an unfair position. They are left to decide whether to disclose unreported income that may stretch back decades (past the statutory limitation period for relief from interest and penalties) when they were unaware that the deceased was committing tax evasion until an examination of the estate is commenced. From the perspective of other, compliant Canadian taxpayers, there is no reason the estate should not be liable for the full sum of back taxes, interest, and penalties. Nevertheless, the discretion granted to the Minister under the taxpayer relief provisions makes allowance for relief from interest and penalties on submission of a valid voluntary disclosure.

One widely publicized example of a voluntary disclosure was the especially generous settlement terms reached with former Prime Minister Brian Mulroney, who had received cash payments and failed to report them to the Minister. One Tax Services Office had dealt with his voluntary disclosure in a manner inconsistent with the treatment by other CRA officials.<sup>101</sup> It is reasonable to assume that the negative publicity around this special treatment of an especially powerful taxpayer contributed to a perception by much of the public that the voluntary disclosure rules “[allow] cheaters to avoid penalties they should be paying.”<sup>102</sup> It is unclear how much of this negative perception is in response to the ministerial discretion granted by the voluntary disclosure rules themselves, or a suspicion that the Minister exercises discretion inconsistently and can be influenced by more powerful Canadian taxpayers.

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100. For an explanation of the relationship between interest and the time value of money, see Lawrence Lokken, “The Time Value of Money Rules” (1986) 42:1 Tax L Rev 1.

101. Sandler & Campbell, *supra* note 8 at 784.

102. Dean Beeby, “Canadian tax cheats come clean amid close scrutiny of offshore havens,” *The Globe and Mail* (14 April 2013), online: <[www.theglobeandmail.com](http://www.theglobeandmail.com)>, referring to a 2011 CRA-commissioned poll.

b. *Taxpayer relief and the settlement process*

Beyond the voluntary disclosures program, taxpayer relief may be granted in extraordinary circumstances that interfere with taxpayer compliance or payment, in particular, events beyond the control of a taxpayer. Tax legislation does not set out the specific circumstances in which relief may be granted, so the Minister has determined that events beyond the control of the taxpayer include natural disaster, serious illness or accident. Other circumstances that may warrant relief are actions of the Minister and financial hardship or inability to pay, typically where the cause of financial hardship goes beyond what the Minister's collections department would consider in negotiating a payment schedule.<sup>103</sup> The Minister will also consider the past diligence and compliance of taxpayers.<sup>104</sup> The Minister has created a sizeable *Taxpayer Relief Procedures Manual* outlining the Minister's administrative guidelines for granting relief under the broad discretion to waive interest or penalties granted by statute.<sup>105</sup> The *Taxpayer Relief Manual* does specify that relief from interest and penalties should not be granted as part of the tax settlement process.<sup>106</sup> However, the Department of Justice can recommend that the Minister waive interest and penalties after the settlement agreement has been concluded.<sup>107</sup> Anecdotal evidence from practitioners also suggests that the Minister is sometimes willing to agree to look favourably on a taxpayer relief request submitted after the conclusion of the settlement and reassessment process. Thus, relief from interest and penalties does get used as a bargaining chip in the tax settlement process. This gives the Minister and the taxpayer flexibility to waive penalties and interest that, beyond a nominal understanding of tax debts, waives the time value of unpaid taxes. The extent of existing ministerial discretion to waive interest (which can be viewed as a waiver of part of the tax debt) and penalties suggests that further expanding the Minister's discretion in concluding tax settlements would be unnecessary.

103. Interest may be waived during a taxpayer's temporary inability to pay, but reinstated when the taxpayer's finances recover, or permanently if the account is uncollectible and the waiver or cancellation will make it possible for some collection to occur. See Canada Revenue Agency, *Taxpayer Relief Procedures Manual* (Ottawa: CRA, May 2013) at s 8.1.1.1-8.1.1.3, online: <v2taxnetpro.com> [*Taxpayer Relief Manual*].

104. See Canada Revenue Agency, Income Tax Information Circular IC07-1 "Taxpayer Relief Provisions" (31 May 2007), online: <www.cra-arc.gc.ca/E/pub/tp/ic07-1/ic07-1-e.html>.

105. *Taxpayer Relief Manual*, *supra* note 103.

106. *Ibid* at 6.1.

107. Some authors have argued that paragraph 5(d) of the *Department of Justice Act*, RSC, 1985, c J-2 allows DOJ lawyers broader discretion to settle tax cases than can be exercised by the Minister. See discussion by Robert G Kreklewitz & John Bassindale "Settlement of Tax Litigation" (2012) 20:2 *Can Tax Highlights* 5. However, DOJ lawyers cannot act without instruction from the CRA, and the CRA cannot instruct them to do otherwise than "administer and enforce" tax legislation.

The Minister keeps track of successful and unsuccessful taxpayer relief requests,<sup>108</sup> and it is possible to request this information, in redacted form, from the Minister under the *Access to Information Act*.<sup>109</sup> It is possible to pick out trends in this information, but not to determine whether discretion to waive interest and penalties is exercised in a consistent manner. According to the results of an access to information request, “[t]otal relief granted peaked at over \$617,500,000 in 2008–2009 (an average of \$10,113 per request), and plummeted 75 per cent to \$156,991,704 in 2011–2012 (an average of \$1,942 per request).”<sup>110</sup> As total relief plummeted, the number of requests for taxpayer relief shot up, perhaps in response to the generous relief that had been granted in 2008–2009. It is possible to speculate that total relief dropped as requests skyrocketed and as the Minister cracked down on the exercise of discretion within the Taxpayer Relief branch. Presumably the Minister attempts to ensure consistency in taxpayer relief decisions through the use of the detailed and lengthy *Taxpayer Relief Manual*, last updated in May 2013.<sup>111</sup> It appears that there is a temporal inequity between taxpayers who applied for taxpayer relief in 2008–2009 or earlier, and taxpayers who applied later, when the average relief per request dropped to approximately 20 per cent of what it had been in the peak year for relief. However, without the ability to examine specific relief requests and results, a conclusion that ministerial discretion has been exercised inconsistently over time remains speculative.

Anecdotal evidence from tax practitioners suggests that discretion is not exercised consistently. The Minister has guidelines to apply in making a decision, but some taxpayers seem to be granted substantial relief when they have not met the guidelines, e.g., for past diligence and compliance with tax filings and payment. Other taxpayers who have been diligent and who otherwise seem to meet the guidelines for extraordinary circumstances and financial hardship may get comparatively less relief or none at all. Some taxpayers who are denied taxpayer relief will challenge the Minister’s decision in Federal Court; however, with no information about circumstances in which relief has been granted (since those facts

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108. See reference to the Taxpayer Relief Registry in *Taxpayer Relief Manual*, *supra* note 103 at s 5.7.1.

109. *Access to Information Act*, RSC 1985, c A-1. The results of one of these requests can be found in A Christina Tari, *Federal Income Tax Litigation in Canada*, vol 1, (Markham: LexisNexis, 2014) (looseleaf revision 37).

110. *Ibid*, ch 4A at 43. Note that these numbers differ from those reported elsewhere, notably \$45 million in interest for 2010–2011 reported by *The Globe and Mail*, *supra* note 102, apparently because *The Globe and Mail* number represents interest relief only, whereas the data gathered for the Tari text combines relief from penalties and interest.

111. *Taxpayer Relief Manual*, *supra* note 103.

remain confidential) it is not possible to determine whether relief is always denied or granted in analogous circumstances.

This lack of transparency in the taxpayer relief context is troubling. While the *Taxpayer Relief Manual* is available as a result of access to information requests, it is far from clear whether the Minister applies the criteria in that manual consistently in exercising discretion to waive interest and penalties for similarly-situated taxpayers. The requirement that tax settlements have a principled basis in law acts as a check against arbitrary exercise of ministerial discretion in the context of tax settlements, which remain confidential. The discretion to waive penalties is not analogous to discretion to waive tax, since the public interest in imposing penalties is distinct from the public interest in making sure all taxpayers pay an amount of tax that is reasonably defensible under the law. The former interest stems from an interest in having appropriate penalties for taxpayers who do not comply with tax legislation, the second stems from concern for fair treatment of all taxpayers, consistent with the principles of horizontal and vertical equity. The discretion to waive interest is, in effect, a mechanism for waiving the time value of outstanding tax liabilities, and can thus be thought of as partial discretion to waive a limited amount of tax on a compromise basis.

The limited ministerial discretion exercised in the realm of interest and penalties does not suggest that the Minister should be granted discretion to waive tax,<sup>112</sup> especially in light of the problems identified with existing discretion, and the suspicion with which the public views taxpayer relief for voluntary disclosures.

#### IV. *The remaining arguments for compromise-basis settlement*

##### 1. *Cost of litigation in a principled-basis system*

Proponents of compromise settlement argue that it would facilitate tax dispute resolution, reducing costs for both the Minister and taxpayers. They also point out that some all-or-nothing tax disputes appear to be impossible to settle on a principled basis because, e.g., a single transaction cannot be divided and characterized partly in favour of the taxpayer and partly in accordance with the Minister's assessment. Therefore, net revenues might increase if the Minister could settle such cases without proceeding to trial. However, most tax disputes can be settled on a principled basis by dividing receipts, expenses, claims for credits, and gains or losses into different legal categories on a factual basis. Most tax disputes are about facts that can be interpreted one way or the other according to the law, and

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112. As suggested in Jackson, *supra* note 8.

there are usually multiple amounts and issues in dispute.<sup>113</sup> It is not clear that tax practitioners are significantly hampered by the requirement that tax settlements must be completed on a principled basis.<sup>114</sup> Settlement on a principled basis forces the parties to turn their minds to the merits of their case. The alternative is settlement on the basis of litigation risk. While litigation risk may make the settlement process more efficient, it is an arbitrary criterion for a settlement process that accords with the rule of law. Tax laws ought to be administered and enforced so that they apply with equal force to all taxpayers. Proponents of compromise basis settlement argue that it may even increase net revenue from the resolution of tax disputes, since single-issue tax disputes will not be forced to litigation before the Tax Court of Canada. Even if this were the case (and there are good reasons to be sceptical, since most tax disputes settle before reaching litigation in the current system) we should view the cost of insisting on a principled basis as a cost of upholding the rule of law in tax administration and enforcement.

## 2. *Principled basis as a barrier for low income litigants*

Critics have suggested that the principled basis itself is a barrier to justice for low-income taxpayers, who are often unrepresented in tax disputes with the Minister.<sup>115</sup> If this is true, the principled basis might pose a de facto problem for vertical equity, since lower income people have fewer resources to deploy in using tax law to settle disputes. According to this position, unrepresented taxpayers may be less able to formulate a principled-basis settlement that accords with tax law than they would be to negotiate a settlement on the basis of litigation risk. However, there is no evidence to suggest that the principled approach itself (as opposed to a simple lack of counsel) puts unrepresented litigants at a disadvantage in settling tax disputes. Without empirical research on the impact of principled and compromise basis settlement systems on unrepresented taxpayers in tax disputes, it is only possible to speculate that one system or another is easier for unrepresented taxpayers to navigate. As easy as it is to assume that the principled basis is difficult for taxpayers to navigate, it is also possible to speculate that the principled basis might be simpler for unrepresented taxpayers to apply. Unrepresented taxpayers

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113. *CIBC World Markets, 2012, supra* note 3 was an example of an all-or-nothing tax dispute; however, it involved a dispute over the interpretation of the law. As noted above, there is value to litigating, and setting a precedent for, points of legal interpretation.

114. See comments to the effect that terms of a principled basis settlement are usually available with some creative drafting in Samtani & Kutyan, *supra* note 35. See also Kroft, "Settlement Strategies," *supra* note 31.

115. See, e.g., Jackson, *supra* note 8.

are in a good position to determine, e.g., which of their expenses can be sacrificed as non-deductible on a principled basis when negotiating with the Minister. Unrepresented taxpayers are perhaps less able to assess the merits of compromise settlement on the basis of litigation risk, since they are typically unfamiliar with the rules and costs of litigation before the Tax Court.

Neither side of the principled vs. compromise settlement debate has empirical grounds to show one system is simpler for unrepresented taxpayers than the other. Either way, the more appropriate path to correct potential inequity towards taxpayers who cannot afford counsel is through access to justice reforms in the CRA appeals process, and in the procedures of the Tax Court of Canada. We have seen the amount-at-risk requirements for the Tax Court's informal procedure, at which taxpayers may be self-represented and rely on relaxed rules of evidence, increase in 2013.<sup>116</sup> Concern for access to justice for low-income and unrepresented taxpayers should be directed at further measures to deal with the fact that the tax dispute resolution process itself can be a barrier to equitable results for those who cannot afford counsel.

### 3. *A U.S. model of offers in compromise in Canada*

Many of the proposals to expand ministerial discretion to settle tax disputes on a compromise basis, including the *Carter Report*, refer to the U.S. system of settlements in response to taxpayers' offers in compromise. The U.S. *Internal Revenue Code* § 7122 specifically authorizes compromise settlements.<sup>117</sup> The Internal Revenue Service's *Internal Revenue Manual* allows for offers in compromise on the basis of "expected hazards [of litigation]," among other criteria.<sup>118</sup> The IRS will also consider doubt as to liability, doubt as to collectability, and offers for the purpose of effective tax administration.<sup>119</sup>

In December 2010, the Tax Executives Institute met with the department of finance liaison, and recommended that the Minister be granted the power to "settle objections based on an analysis of litigation

116. See Tax Court of Canada, "Practice Note 19 'Informal Procedure'" (20 January 2014), online: <cas-ncr-nter03.cas-satj.gc.ca/portal/page/portal/tcc-cci\_Eng/Process/practice19>: aggregate amounts at risk and subject to the informal procedure are increased to \$25,000 and losses in issue are increased to \$50,000.

117. 26 USC § 7122 (2015) [IRC]. See also 26 CFR § 301.7122-1 (1997) [*Treasury Regs*].

118. See US, Internal Revenue Service, "Legal Advice" in Internal Revenue Service, *Internal Revenue Manual* (Washington, DC: IRS, 2004) Part 33 at 33.3.2.3.1, online: <www.irs.gov/irm/part33/irm\_33-003-002.html> [IRM].

119. See discussion in McNary, Lynch & Lévesque, *supra* note 78 at 14:7, and IRM, *supra* note 118 at 33.3.2.

risk.”<sup>120</sup> The “risks of litigation” language is similar to that used in the United States’ tax dispute resolution process. The recommendation was rejected by the departments of justice and finance. The department of finance added that “they were ‘uncomfortable from a ‘checks and balances’ view to grant additional authority to the CRA’, and favoured a ‘principles-based approach’ to settlement.”<sup>121</sup> Finance’s position is consistent with the *Carter Report*’s concerns about risks of ministerial discretion, if not with its recommendation that a U.S.-style system be introduced in Canada.

The department of finance may also be concerned that allowing compromise settlements would incentivize taxpayers to threaten litigation in order to settle for less than the tax owed.<sup>122</sup> Settlement on the basis of “expected hazards [of litigation]”<sup>123</sup> would clearly be inappropriate in such situations, and an increase in tax disputes would be an unfortunate consequence of a policy intended to expedite settlement. Indeed, the United States does seem to have a large volume of baseless offers in compromise. CNBC reported that, in 2007, approximately 75 per cent of taxpayer requests were rejected.<sup>124</sup> However, many of these were “frivolous requests,” which are “often...advanced in large batches by firms that market this service for a contingency fee.”<sup>125</sup> In order to manage the administrative burden created by this flood of apparently baseless settlement offers, § 7122(f) of the *Internal Revenue Code* specifically allows the Secretary to treat frivolous submissions as though they were “never submitted and such portion shall not be subject to any further administrative or judicial review.”<sup>126</sup> Including such a provision in any Canadian legislative amendment could mitigate the problem of incentivizing tax disputes through legally sanctioned compromise settlements. However, it would introduce another troubling instance of ministerial discretion: discretion to ignore offers in compromise with no opportunity for judicial review. In the U.S., this extraordinary discretion appears not to have completely prevented the submission of large numbers of frivolous offers in compromise. It has often been suggested that there would be a cost reduction to the Canadian government of tax

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120. Ed Kroft, “Dealing with Tax Officials: Selected Issues in Administration, Enforcement and Appeals” in Canadian Bar Association, *2011 Tax Law for Lawyers* (CBA, 2011) 1 at 49.

121. *Ibid.*

122. See, e.g., Tari, *supra* note 109 at s 9.3.

123. *IRM*, *supra* note 118.

124. CNBC, *supra* note 78 and McNary, Lynch & Lévesque, *supra* note 78 at 14:7.

125. *Ibid.*

126. *IRC*, *supra* note 117, as amended. Note that there are two subsections (f) to this section. I refer to the latter. Administrative review is available where the Secretary has not deemed such submissions to be frivolous.

dispute resolution if compromise settlements were permitted on the basis of litigation risk.<sup>127</sup> It is not obvious that costs would be reduced, since granting the Minister discretion to make compromise settlements would simply add another layer of argument to every tax dispute and could invite frivolous offers in compromise from taxpayers, as has been the experience in the U.S.

A contrary view from a practitioner in the U.S. is that the ground of effective tax administration for offers in compromise is underutilized in part because they are so often rejected by the IRS, and there is a resulting perception that such offers are typically rejected.<sup>128</sup> Where an effective tax administration application does not involve hardship, the taxpayer must demonstrate that “collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner.”<sup>129</sup> Further, “[n]o compromise to promote effective tax administration may be entered into if compromise of the liability would undermine compliance by taxpayers with the tax laws.”<sup>130</sup> These seem like difficult criteria for a taxpayer to meet, since they appear to involve speculation by the taxpayer that horizontal equity would be maintained were the offer accepted. The IRS is criticized for taking a restrictive approach to considering such offers. The IRS states that, “[b]ecause the Service assumes that Congress imposes tax liabilities only where it determines it is fair to do so, compromise on these grounds will be rare.” This is said to exemplify a problem with the IRS’s attitude towards this type of settlement—even though this type of application does not involve a claim of financial hardship.<sup>131</sup> The IRS’s position on the application of the tax law appears entirely reasonable, if viewed from the perspective of all U.S. taxpayers, most of whom are presumably compliant with U.S. tax laws. Exceptions to the even-handed application of tax law to all taxpayers should be just that—exceptional. The Treasury Regulations, correctly from this perspective, prevent the IRS from accepting effective tax administration offers, absent hardship, except where public confidence in the tax system is protected by the offer itself. The legal framework for determining taxes owing in the U.S., as in Canada and other jurisdictions, is grounded in judgments about who owes tax on what receipts in what circumstances. Tax administrators should not be in the business of

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127. Hogg, Magee & Li, *supra* note 55 at 569-570 and Jackson, *supra* note 8 at 308.

128. Sandy Freund, “Effective Tax Administration Offers in Compromise—Why so Ineffective?” (2014) 34:1 Va Tax Rev 157.

129. *Treasury Regs*, *supra* note 117, § 301.7122-1(b)(3)(ii).

130. *Ibid*, § 301.7122-1(b)(3)(iii).

131. Freund, *supra* note 128 at 173.

effectively legislating special exceptions to those judgments. There is some value in getting to an amount of tax owing that is defensible under the law. As the American economist Henry Simons said in the context of justifying progressive taxation:

The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely.<sup>132</sup>

In a democracy, our collective judgments about the correct amounts of tax owing in particular circumstances should be reflected in the tax law just as our judgments about the progressivity of the tax system are. Those judgments ought not to be overridden by administrators in reaching compromise settlements that do not have a principled basis in law. Additional discretion risks introducing additional fairness concerns if discretion is exercised in an inconsistent manner. The IRS's restrictive interpretation of its ability to accept offers in compromise on public policy or equity grounds is justified. Such circumstances might be akin to the exceptional circumstances in which taxes can be waived by a remission order in Canada.

It should be noted that the effective tax administration category (on public policy grounds where no hardship is claimed) for offers in compromise is part of one of three grounds for offers in compromise in the U.S.<sup>133</sup> Taken together, the grounds for compromise settlement in the U.S. would be redundant in the Canadian context. Doubt as to liability can, in most cases, be settled on a principled basis grounded in a defensible interpretation of the facts and law, while disputes as to the correct interpretation of law can and should be decided by the courts.<sup>134</sup> Doubt as to collectability is dealt with in the Canadian context by ministerial discretion to negotiate payment plans with taxpayers, and through bankruptcy proceedings as a last resort. The last criterion, of effective tax administration, covers two kinds of circumstances. First, where enforcing the black letter of tax law would cause taxpayers to suffer financial hardship.<sup>135</sup> Second, where as a

132. Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938) at 18-19.

133. Only 3 per cent of offers in compromise submitted in 2013 are effective tax administration offers that do not involve circumstances of economic hardship. Freund, *supra* note 128 at 157.

134. See the discussion of *CIBC World Markets, 2012*, *supra* note 3, in the "Assessing the Jurisprudence" section of this paper, above.

135. See *Treasury Regs*, *supra* note 117, § 301.7122-1 and Oei, *supra* note 13 at 1080-1081, referencing the *Internal Revenue Service Restructuring and Reform Act of 1998*, Pub L No 105-206, 112 Stat 685 (codified as amended in scattered sections of the IRC).

matter of public policy or equity, it would undermine public confidence in tax administration to collect the full liability. The first aspect is covered in the Canadian system by ministerial discretion to provide taxpayer relief from interest and penalties, and the ability of collections officers to negotiate repayment plans. The second is covered by the availability of remission orders to clear tax debts in exceptional circumstances. In light of the availability of mechanisms in Canadian law allowing relief in circumstances comparable to those where offers in compromise are granted in the U.S., and given the significant administrative burdens that would be placed on the Minister if offers in compromise were permitted in Canada, it appears unnecessary to introduce such a system in Canada.

#### 4. *Tax settlements and the social safety net*

It has been suggested that the offer in compromise system forms part of the social safety net in the U.S., due in part to the fact that relief is available to taxpayers who would experience financial hardship.<sup>136</sup> Taxpayers who are driven to financial ruin by paying their tax liability may end up taking resources back from the government in the form of various social security supports for low-income taxpayers. Proponents of this view argue that taxpayers' future earning capacity may also be reduced, reducing net revenue collection compared to a compromise system.<sup>137</sup> This theory of tax settlement raises a conceptual problem. According to this theory, relief from taxes under a compromise system should be considered a tax expenditure, constituting social spending. The lack of transparency, and high probability of inconsistency in permitting compromises on tax owing to protect taxpayers from hardship, suggests that this kind of social spending should be limited to extraordinary circumstances. The government could not be held accountable for tax settlements concluded in private, or justify the possibility of spending more on tax debtors in tax settlements than other low-income people would receive in social security transfers. If the general taxpaying public must support former tax debtors through existing social security transfers, the aid provided to those former tax debtors is at least transparent and comparable to the supports that a tax compliant low income-person would receive.<sup>138</sup> The case for expanding this discretion as part of a social spending program, instead of merely

136. See Jackson, *supra* note 8, referencing Oei, *supra* note 13.

137. See, e.g., Oei, *supra* note 13.

138. *Ibid* at 1086-1093, deals with this objection by taking issue with the benchmarks of pre-tax income and tax assessed, pointing out various indeterminacies in defining these amounts. This paper relies on different premises: that there is value in enforcing tax assessed, since the tax law reflects social and economic judgments in a democratic society, however murky a reflection the tax law might be.

to facilitate settlement, is not compelling because of the probability that tax concessions (i.e., spending) would become dependent on the litigious nature of some taxpayers, and the resources they can deploy in disputes with the Minister. The potential for financial ruin of taxpayers is addressed already through the bankruptcy process,<sup>139</sup> through negotiations with collections officers, and through taxpayer relief. Additional relief, in the form of government revenue forgone, should not be provided to taxpayers who owe more in tax than their total net worth. Such taxpayers may have simply engaged in risky ventures or otherwise squandered their means. These taxpayers should not be further underwritten by the social safety net; they already have recourse to other mechanisms of relief in the Canadian system.

#### V. *In defence of the principled approach*

The expansion of the Minister's discretion to reach settlements on a compromise basis is not justified by any flaw in the current system of principled-basis settlement. The *Carter Report* recognized the problems with ministerial discretion to grant or deny advance ruling requests, at least in the context of fairness to taxpayers making those requests. The same problems apply in the settlement context: concern for fairness to individual taxpayers and concern for equity between taxpayers ought to bar the expansion of ministerial discretion, especially since no pressing need for expanding that discretion has been demonstrated. Nevertheless, calls to expand ministerial discretion to settle tax disputes on a compromise basis, often modelled on the U.S. system, continue to be made.

The requirement that tax settlements be made on a principled basis creates a barrier to settlement in very few cases. This is evidenced by the fact that some 90 per cent of tax disputes are resolved by settlement at the pre-litigation stage.<sup>140</sup> Even more are settled in the litigation process. Given the high proportion of disputes that are settled, it appears that the tax settlement regime in Canada is functional as is. Legislative reform might only create inequities as a result of inconsistent exercise of ministerial discretion, and as a result of some taxpayers paying less than similarly-situated taxpayers with no principled basis for arriving at different settlement terms. The flexibility to settle on a principled basis, using some range of defensible interpretations of facts in dispute, is already built into the Canadian tax system. That this flexibility could be construed as an existing power to settle on the basis of litigation risk does

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139. This is recognized even by authors advocating compromise settlement in Canada. See, e.g., Jackson, *supra* note 8.

140. Sandler & Campbell, *supra* note 8 at 764.

not justify extending ministerial discretion to settle tax cases without any principled basis in law. The current state of affairs is far preferable to one in which tax settlements are permitted solely on the basis of litigation risk, where the parties may reach an enforceable settlement without turning their minds to settling on the merits at all.

The most basic purpose of taxes is to raise government revenue. In a perfect democracy, tax legislation would codify society's collective judgments about who should pay taxes, when, and how much. In the real world, tax laws at least reflect some of society's judgments about our financial responsibilities to one another. In Canada, the Minister is charged with administering and enforcing tax legislation. She is therefore charged with administering and enforcing a reflection, however imperfect, of those judgments. We ought to insist that, when the Minister settles a tax dispute with a particular taxpayer, she has ensured the amount of tax settled upon is in conformity with a reasonable interpretation of how the relevant tax statute applies to the circumstances of that taxpayer. Splitting the difference in dispute would do a disservice to other Canadian taxpayers who have the right, in a legal system governed by the rule of law, to expect that the Minister is administering and enforcing the same tax laws with which they must comply. A principled basis for tax settlements is what tax legislation in Canada does, and should, demand.