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Litigation as a Route to Resolution

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Many tax disputes are successfully resolved without resort to the courts. In other cases, however, litigation may offer taxpayers a uniquely effective, and potentially a more expeditious, avenue of recourse. In this paper, the author reviews the process for litigating disputes in the Tax Court of Canada and examines the various ways in which that process can provide relief to taxpayers who are keen on achieving early resolution.

To Appeal or Not To Appeal

The statutory regime for tax appeals is a specialized and exclusive system. Sections 169 to 171 of the *Income Tax Act*[1] describe the circumstances in which a taxpayer may pursue an appeal to the Tax Court, the procedure to be followed in doing so, and the manner in which the appeal may be resolved.

In determining whether to commence an appeal, a taxpayer must first consider the utility and desirability of bypassing the internal review process administered by the Appeals Branch of the Canada Revenue Agency (CRA). Resolution of a dispute at the Appeals Branch necessarily avoids the professional fees associated with pursuing an appeal and, in many cases, may be the recommended course of action. For example, in situations where the CRA has clearly misperceived the facts or misapplied the law, the Appeals Branch will likely be persuaded to vacate the assessment.

In other situations, it may be preferable for the taxpayer to proceed directly to the Tax Court. For instance, if a specialized committee within the CRA (such as the Transfer Pricing Review Committee or the GAAR Committee) has already taken a position on the merits of an issue and the Audit Branch has simply followed suit, it may be unlikely that the Appeals Branch will take a contrary position.

A tax appeal is a matter of public record. Materials that are filed with the Tax Court are publicly available, subject to any confidentiality order that may be issued by the court. Specific details such as the quantum of tax assessed may be accessible if they are included in the pleadings; if the appeal proceeds to trial, other details relating to the dispute may be revealed in published reasons for judgment. A taxpayer concerned with reputational risk may be reluctant to commence an

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

appeal for this reason. The Crown may be similarly reluctant to proceed with a case that may set an unfavourable precedent.

Despite the public nature of an appeal and the associated costs of litigation, a taxpayer may nonetheless decide that it wishes to bypass the Appeals Branch. Timing and other non-tax considerations may dictate the need for early resolution. In almost all cases, due to backlogs within the system, it can take several months, if not years, before an objection is assigned for review, and it may take even longer for the Appeals Branch to consider and rule on the objection.[2] Further, in cases where the taxpayer has paid the assessed amount (either by choice or pursuant to a statutory obligation), there is a cost associated with increased delay. In such cases, the taxpayer may not be inclined to have the clock tick indefinitely.

If a taxpayer wants to advance a dispute quickly, there may be limitations that do not allow the Appeals Branch to take early action. But if a notice of objection has been filed and 91 days have elapsed, the taxpayer has the opportunity to commence litigation.[3] If there is reason to believe that a dispute is destined to be resolved through the judicial process, there may not be any practical advantage for either the taxpayer or the Appeals Branch to engage in a protracted review of the objection.

It bears noting that the pursuit of a dispute is a process and not merely an event. At various stages in the process, the focus and texture of the dispute can change. For example, if the Appeals Branch considers an objection and in the course of doing so makes additional assumptions of fact, the taxpayer normally bears the burden of disproving those assumptions in the Tax Court if the matter proceeds to trial.

The boundaries of the dispute may remain fluid at the objection stage. With the benefit of additional time, the Appeals Branch may have the opportunity to formulate new arguments and consider additional reasons to uphold the assessment. Although a taxpayer remains entitled to address those arguments and reasons in the normal course, their existence may alter the course of a dispute and require the taxpayer to reconsider whether and how the dispute should proceed, either substantively or procedurally.

Strategic Benefits of Litigation

In determining whether and in what circumstances it is preferable to proceed to the Tax Court, it is necessary to consider the strategic benefits afforded by litigation. The single most important advantage of commencing an appeal is access to the court process. That process comes with court-imposed directives and timelines. There is a defined structure within which both the taxpayer and the Crown must operate and, as discussed further below, the court process also offers the parties several opportunities to settle.

Another potentially significant benefit of commencing an appeal is the early engagement of the Department of Justice. The CRA will often seek legal advice from Justice, but this consultation does not necessarily allow for access to Justice counsel at the objection stage. In contrast, when

2 In Canada Revenue Agency, *Annual Report to Parliament 2012-2013* (Ottawa: CRA, 2012) (www.cra-arc.gc.ca/gncy/nnnl/2012-2013/images/ar-2012-13-eng.pdf), the CRA stated that it took several steps to simplify and improve its workload management processes, which resulted in reducing the average age of the disputes in its inventory. However, the CRA also stated that on average it took 174 days to resolve an income tax dispute at the appeals stage during the 2012-13 year and 193 days to resolve commodity tax disputes.

3 Paragraph 169(1)(b)

an appeal is commenced in the Tax Court, a Justice lawyer is assigned to the file and necessarily introduces an independent perspective. Deliberations with Justice, for example, can assist in resolving disputes pertaining to issues in the taxation years under appeal and other years that are under objection when identical issues are raised, possibly offering additional scope for settling latent as well as active disagreements between the taxpayer and the CRA.

When parties are in the litigation process, one of the very first steps that each party must take is to analyze its case and develop a cohesive, focused, and coherent theory of how the Act should be applied in the circumstances. This process requires the parties to scrutinize the facts and to evaluate them in the context of an overall strategy. In other words, the taxpayer and the Crown can be expected to commit to their respective positions in pleadings that are, of course, publicly available. Thus, the disciplined nature of the process may itself contribute to the resolution of a dispute without the need for further action, or in any event it may crystallize the dispute in a way that facilitates more focused settlement discussions.[4]

The Process

To appreciate the settlement possibilities that can materialize once litigation is in progress, it is important to be aware of the various steps in the process. Pleadings are the first step; these documents are used to formally commence proceedings in the Tax Court. They serve to define, and therefore confine, the matters at issue between the parties.

The primary pleading filed by the taxpayer is the notice of appeal. This document, which outlines the nature of the dispute, is the first document to be filed with the Tax Court. As such, it offers the taxpayer an opportunity to set out its side of the story and to tell the court why the assessment is wrong as a matter of fact, a matter of law, or both.

In turn, the Crown is obliged to file a reply and take a position in respect of the facts that are pleaded by the taxpayer. To the extent that the Crown admits any of those facts, the dispute is naturally confined. The Crown must also set out in the reply all of the factual findings or conclusions that the CRA made before issuing the assessment. The reply can therefore be quite useful in understanding the basis on which the assessment was raised.

The taxpayer has the option of filing an answer when material facts are asserted in the reply that can be admitted or should be denied, or where new arguments are advanced in the reply that might leave an unfavourable first impression with the court if they are not addressed. The taxpayer is deemed to deny any allegations of fact made in a reply if no answer is filed.

One of the first opportunities to discuss settlement arises after the pleadings have been filed. The boundaries of the litigation have been set at this stage. Each party has committed, at least in principle, to its position, and it is relatively easy at this point to determine whether there is any room to negotiate.

After the pleadings are filed, the next step involves the disclosure of documents and discovery. This step enables the taxpayer to access all of the documents underlying the assessment—internal

4 During 2012-13, the CRA conducted an internal evaluation of its effectiveness in addressing taxpayer-contested decisions. In a report that documented its findings, the CRA acknowledged that "the majority of the Tax Court cases (52%) were resolved without a hearing before a judge, most often resulting in a full or partial consent between the taxpayer and CRA (73%)." See Canada Revenue Agency, Corporate Audit and Evaluation Branch, *Tax Appeals Evaluation: Final Report* (Ottawa: CRA, May 2012) (www.cra-arc.gc.ca/gncy/ntrnl/2012/txpplsvltn-eng.html), at section 5.1.2.

CRA correspondence, notes and memos, and even minutes of internal CRA committee meetings. For taxpayers who may have attempted to obtain copies of such documents through parallel, and possibly duplicative, requests under the access to information procedure, the discovery process offers welcome respite.

In its most essential terms, discovery enables the taxpayer to (1) discover the facts on which the Crown relies in support of the assessment; (2) narrow or eliminate the issues in dispute; (3) obtain admissions on the facts; and (4) effectively avoid surprises at trial. Discovery also represents another opportunity to raise and actively pursue the possibility of settlement. By this time, each party is better aware of the case that it will have to meet at trial, and it may have become more realistic about its chances of success.

After discoveries have concluded, the next step that the parties might consider is to request a trial management conference.[5] This type of conference imposes discipline on the trial process because the court can give any directions that are necessary for the most expeditious and least expensive resolution of the case, including the possibility of obtaining admissions. During the conference, the parties can also discuss the most appropriate means of simplifying the issues and shortening the hearing.

If the matter cannot be settled at any one of these pre-trial stages, the parties may consider proceeding to trial. Nevertheless, an appeal may settle even after trial and before the court issues a judgment.

The Procedures

CASE MANAGEMENT

The litigation process offers taxpayers a variety of specific tools to resolve their disputes, including access to court procedures. A very useful procedure that is available to litigants in the Tax Court is case management.[6]

The court, on its own initiative or at the request of the parties, can order that an appeal (or a group of appeals) be managed by designating a judge to act as the case management judge. Once assigned, the case management judge will ensure that the parties have agreed on a timetable for completing the various pre-trial steps and address any preliminary differences of opinion.

The Chief Justice of the Tax Court has described the role of a case management judge in the following terms:

> The judge knows what the litigation is about: he or she looks at the timelines, deals with the motions, gives the directions, organizes the litigation, gets it ready for trial, resolves some issues that might hold things up, and keeps the parties in their own corners. But he or she also—and this is very important—allows the litigators to litigate the files. It is their strategy they want to put in place, not the judge's. The judge just wants to make sure that the matters move along consistently, evenly, and logically, and with as little rancour as possible; the judge wants to get the case ready for trial, get it focused, and get it narrowed down, so that when he or she passes it over to the trial judge, the trial judge

5 Rule 126.1 of the Tax Court of Canada Rules (General Procedure), SOR/90-688a, as amended.
6 Ibid., at rule 126.

just sits there and the case is good to go. That's the whole purpose of case management.[7]

In sum, the case management judge serves as independent arbiter in ensuring that the appeal proceeds in a fair and efficient manner. He or she will not normally preside over the trial, but will deal with all matters that arise prior to the hearing and give directions that allow for the most expeditious, and least costly, determination.

SETTLEMENT CONFERENCES

At any stage in the litigation process, and well before proceeding to trial, the parties may consider a settlement conference.[8] Such a conference is generally held for the purpose of exploring the possibility of settling some or all of the issues raised in the appeal. When considering settlement, parties must determine as a preliminary measure whether there is a principled basis for settlement, since the CRA will generally not agree to a compromise settlement that is based solely on litigation risk and that does not reflect a defensible view of the facts and law.[9]

A relatively recent and very helpful development in relation to settlement is the availability of enhanced costs awards when settlement offers are made in writing.[10] In essence, this rule requires the opposing party to pay substantial indemnity costs (that is, 80 percent of solicitor and client costs) after the date of the offer if the result achieved after a trial is less favourable than the settlement that was formally offered. It is aimed at encouraging parties to make settlement offers and to treat them seriously when made.

Settlement conferences occur in confidence. In such conferences, parties typically assert positions and make proposals for compromise, and often the presiding judge will offer views and suggest proposals. Thus, even if the settlement conference itself is not successful, at the very least it has the effect of clarifying the issues for trial.

A judge who presides at a settlement conference will subsequently not preside at the hearing. Conference briefs are similarly not available to the trial judge or to members of the public. Settlements are also generally implemented through minutes that are kept confidential.[11]

PRE-TRIAL MOTIONS

After all pre-trial steps are completed, the parties may apply to set the matter down for hearing. It should be noted, however, that there are several mechanisms within the court process which can allow for resolution short of a trial.

As a general rule, motions and other pre-trial disputes should be kept to a minimum, especially when such disputes reflect either the inability or the unwillingness of the parties to cooperate. In the right circumstances, however, motions can be an integral part of the litigation process, and

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7 Hon. Eugene Rossiter, Hon. Wyman Webb, Ken Skingle, and Jehad Haymour, "Tax Litigation: Current Topics," in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 31:1-20, at 31:10, per Hon. Eugene Rossiter.

8 Tax Court of Canada Rules, supra note 5, at rule 126.3. Note that each party must serve on the other party and file with the court at least 14 days prior to the date of the conference a brief that, among other things, sets out its theory of the case.

9 *CIBC World Markets Inc. v. Canada*, 2012 FCA 3, at paragraph 22.

10 Tax Court of Canada Rules, supra note 5, at rule 147(3.1).

11 Minutes of settlement reflect a private agreement between the taxpayer and the minister, which is not reviewed or endorsed by the court. Because the taxpayer normally withdraws or discontinues its appeal when minutes are used, in such cases the court will not issue a judgment that incorporates the terms of the minutes. The parties can therefore address issues in the minutes that were not raised by the pleadings and agree to relief that the court would not otherwise have the power to grant.

they deserve particular attention in cases where such procedures can affect the outcome of the dispute itself.

For example, if a motion to strike is timed correctly, it can be quite effective in confining, if not entirely eliminating, key issues in dispute, and it can serve to streamline the rest of the litigation, especially if the pleadings at the outset are poorly drafted.[12]

A motion for particulars can serve the same purpose by enabling a party to know precisely the case it must meet at trial. The purpose of pleadings is generally to delineate the facts and issues in dispute between the parties and to set the parameters of the appeal, including the scope of discovery. If a pleading fails to meet this standard, a party can take steps to compel the opposing party to particularize its position.[13]

RULE 58 DETERMINATIONS

A useful mechanism to resolve a dispute in the Tax Court without a full-blown trial is a determination under rule 58 of the Tax Court Rules.[14] Rule 58 provides that a party can apply to the court for the pre-trial determination of a question of law, fact, or mixed law and fact, and the court may grant judgment accordingly.

A party can apply to have a question determined, or both parties can agree that a question is appropriate for determination. The granting of any such application is discretionary. Parties are not generally entitled, as of right, to carve out a discrete issue or question from a proceeding and have it heard separately.[15]

In some cases, however, the issues are capable of being isolated[16] —for example, when material facts are not in dispute and the resolution of any disputed facts does not depend on the credibility of witnesses. In such a case, the determination can occur just after the pleadings have closed and well before discovery. Depending on the outcome, the determination of one issue may also provide the additional benefit of spurring the parties into settlement.

PRO TANTO JUDGMENTS

A tax appeal can also be streamlined through an application under subsection 171(2). This provision is a relatively recent enactment, and its application in the future remains to be seen. In essential terms, however, it empowers the Tax Court to resolve a particular issue if both the parties to the appeal and the court agree that the issue should be dealt with separately.

Previously, if the assessment involved more than one issue, all of the issues had to be addressed within a single appeal. Now, however, the parties can apply to the court to dispose of such issues separately. This leads to a pro tanto judgment, or a judgment that deals with one part of an appeal.

Taxpayers are periodically faced with reassessments involving one or more issues that by their nature are less likely to settle and more likely to require a judicial determination. At the same time, there may be other less complex or less contentious issues that are amenable to settlement. Under subsection 171(2), a complex or contentious issue may be hived off from the rest of the

12 See, for example, *Canadian Imperial Bank of Commerce v. Canada*, 2013 FCA 122.
13 *Mastronardi v. The Queen*, 2010 TCC 57, at paragraph 12. See also *Birchcliff Energy Ltd. v. R*, [2013] 3 CTC 2169 (TCC).
14 Tax Court of Canada Rules, supra note 5, at rule 58.
15 Refer also to the discussion of subsection 171(2) below.
16 See, for example, *Devon Canada Corporation v. The Queen*, 2013 TCC 4 and 2013 TCC 415.

appeal, leading to an earlier resolution of the more straightforward issues through settlement.

The purpose of subsection 171(2) is to allow for greater flexibility in managing tax litigation. Appeals to the Tax Court in respect of the parked issues can still continue after the partial disposition. Appeals to the Federal Court of Appeal may also be taken from a partial disposition while the parties proceed with litigating the parked issues in the Tax Court.[17]

SUBSECTION 173(1) REFERENCES

Taxpayers seeking to streamline the litigation process may also consider a reference to the Tax Court under subsection 173(1).[18] This is a procedure in which the court can determine a question of law, fact, or mixed law and fact in respect of any assessment,[19] including a proposed assessment that has yet to be issued. In all other cases, the taxpayer must file an objection and commence an appeal before availing itself of the court process.

Subsection 173(1) is notably broad. It allows the parties to advance a question at any time (even as early as the audit stage) and obliges the court to determine that question. Thus, from a practical perspective, a reference can serve as a very valuable means of resolving particular issues on an expedited basis.

Unfortunately, this procedure is not routinely invoked; it requires the minister to consent, and thus the parties to agree on the exact question to be determined.[20]

Building Your Best Case

The resolution of disputes can be made more complicated, or even compromised, simply because the taxpayer never anticipated the prospect of litigation. If there is even the slightest chance that a dispute might eventually progress to the Tax Court, it is important to be aware of that possibility and plan accordingly.

The following are a few measures that taxpayers should keep in mind at the planning stage and implement where appropriate.

First, taxpayers should develop lists of relevant facts well in advance of any audit and implement a document management system. Files should be organized, privileged documents should be kept segregated, and other documents should be properly stored, so that they can be easily accessed years later if the need arises. Any such system should also ensure that documents prepared in the context of a transaction are prepared consistently with the position that the taxpayer intends to take in respect of the transaction at the audit stage.

Second, taxpayers should maintain a detailed inventory (and chronology) of the information and documents provided to the CRA in the course of the audit. Such a summary is useful in

17 Note the comments of Hon. Wyman Webb of the Federal Court of Appeal with respect to parked issues and the preservation of evidence in "Tax Litigation: Current Topics," supra note 7, at 31:3.
18 Section 310 is the parallel provision in the Excise Tax Act, RSC 1985, c. E-15, as amended.
19 See, for example, *Imperial Oil Limited v. The Queen*, 2004 TCC 207.
20 Refer to the CRA *Appeals Manual* (Ottawa: CRA), at section 7.19.4, for the circumstances in which the CRA may consider this procedure. As the CRA notes, "A good example of an appropriate application would be where the taxpayer is alleging an assessment is both statute-barred and incorrect. If successful on an application on the statute-barred issue, there is no need to deal with the substantive issue. The time and costs of a discovery and trial would be avoided."

(1) demonstrating that the taxpayer cooperated during the audit process, (2) documenting the information that the CRA had available in pursuing any potential assessment, and (3) assisting the taxpayer and its advisers in any further steps.

Documents should be carefully reviewed before disclosure to the CRA. Such a review process is critical in identifying documents that are subject to privilege (and therefore do not have to be produced) and documents that may be unfavourable and require further explanation to be properly understood.

Finally, electronic discovery is more widely used in the tax context than in the past. Taxpayers and CRA employees should anticipate that all relevant materials (electronic and otherwise) may be producible, and they should govern themselves appropriately in composing their e-mails and other correspondence.

Conclusion

Tax disputes are on the rise. Although such disputes are best resolved by agreement, it is important for taxpayers and their advisers to appreciate that litigation, in the tax context, is a viable option. Contrary to popular opinion, it does not equate in all cases to an expensive, uncertain, or time-consuming process. Rather, in many cases it can represent a structured and cost-effective path to resolution.

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