

# **TACTICAL TAX PLANNING®**

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**By**

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## **INTRODUCTION**

Despite the recent recession, Canada (like the rest of the developed world) has witnessed an exponential increase in wealth creation over the past 30 years.<sup>1</sup> Unfortunately, the majority of HNWI's looking to do some sort of tax planning engage in transactions that have no effective value or cause significant collateral problems with CRA. These plans include:

1. Registered tax promoter products, such as art flips, film and software deals or charitable schemes of various kinds, which usually prompt automatic taxpayer audits due to their tax identification status;
2. Registered tax deduction programs that have no inherent investment value or tax savings, such as flow through shares, labour promoted mutual funds and RCA's;
3. Reinvestment transactions that continually defer tax by redeploying gains, which usually results in an overwhelming tax burden at some point in the future;
4. Mass marketed plans that provide very little tax benefit relative to a HNWI's tax burden, including RSP's and TSFA's; and
5. Hiding taxable income in offshore bank accounts, which is obviously illegal.

What is missing from the mix is legitimate tax planning that brings real economic benefit for High Net-Worth Individuals ("HNWI's")<sup>2</sup>.

This paper attempts to analyze why the majority of HNWI's don't engage in substantive planning and to propose a solution which is referred to as "Tactical Tax Planning"®.

## **WHY DON'T MORE PEOPLE TAX PLAN?**

Based on discussions with hundreds of HNWI's over the past 20 years, the three major reasons that HNWI's do not use more sophisticated tax plans are as follows:

1. Lack of knowledge about the existence of the plans;
2. Expense and complexity; and
3. Apprehension that they may be breaking the law.

### ***Lack of Knowledge***

Sophisticated tax planning is not a volume service. The target market is much smaller than it is for general financial services, therefore it is hard to get any scale for volume transactions. Also, sophisticated tax planning is intricate and customized, requiring specific input by professional advisors. As such, it is again difficult to promote because it is hard to generalize the attributes and benefits.

Given that it is hard to scale and difficult to market, sophisticated planning is not the subject of large-scale advertising campaigns as we see with RSP's and TSFA's.

Also, given the economic business model of the professional law and accounting firms (discussed more below), it is difficult for clients to do any "grass-roots" education on their own. Unfortunately, they often get side tracked by tax promoter products, which give the illusion of benefiting taxpayers with greater needs, but unfortunately use cookie cutter solutions that are open to attack by CRA.

### ***Expense and Complexity***

As the number of HNWI's has increased over the past 30 years, the Canadian government has implemented more and more complex legislation to try to stop planning techniques, including advisor penalties.

With the increase in legislative complexity and the advent of professional penalties, general practitioners have moved away from providing private client tax advice. The ones that have stayed, or have been recruited into the area, are more specialized. Typical to a specialized business model, the hourly rates have gone up dramatically. Most tax specialists now charge between \$600 and \$800 per hour, with the top earners charging up to \$1,000 per hour.

In addition to the increase in expense, specialization has resulted in practitioners being more technical in nature. This often results in severe communication challenges with client prospects.

Lastly, there are issues with the service providers that help to implement the tax plan itself, especially with the international service providers. As the developed nations work to maintain their tax base in the face of globalization, supra-national federations such as the OECD<sup>3</sup> put pressure on international finance centres, (such as Bermuda and the Cayman Islands) to make it more difficult for them to do volume business.

One of the ways they do this is to make demands regarding due diligence (the substantiation of the identity of the client and the source of the tax planning funds). Stricter due diligence requirements increases the complexity and cost to implement tax plans.

### ***Apprehension that they may be Breaking the Law***

Many of the client prospects that I have spoken with over the years are under the misapprehension that they may be breaking the law by engaging in sophisticated tax planning. Over the past several years there has been a concerted effort by CRA and the Ministry of Finance to blur the identification between tax evasion and legitimate tax planning.

It can be argued that the process began with the implementation of the General Anti-Avoidance Rule, which created a concept of “abusive” tax avoidance versus legitimate tax planning. The latest effort can be seen in the attempt by the Federal and Quebec governments to codify the concept of “aggressive” tax planning.<sup>4</sup>

These legislative reforms (combined with the professional advisor penalties), have created a certain reluctance by many advisors to promote sophisticated planning. This has led to a widespread belief amongst taxpayers that there is no ability to tax plan outside of specifically approved schemes (such as RSP’s). Moreover, with media coverage and CRA press releases in relation to specific cases of high profile tax evasion, the average taxpayer is left with the idea that they may in fact be breaking the law simply by engaging in sophisticated (but legitimate) tax planning.

### **WHAT’S THE SOLUTION? – TACTICAL TAX PLANNING®**

Tactical Tax Planning® (“TTP”) is the concept of engaging in tax planning strictly on the basis of a risk versus reward allocation model. It attempts to minimize fear and uncertainty in engaging in sophisticated planning by establishing a system that allows the client to quantify his or her gains and potential downside.

#### *What is the risk?*

There are two elements that comprise the risk. The first element is the chance of being reassessed in relation to the plan. The second element is the quantification of what would be potentially owed in relation to a settlement of a reassessment.

Only about 1% of corporate returns and 1.3% personal returns are audited annually.<sup>5</sup> While a majority of the audited returns are reassessed in some form or fashion, a vast number are settled immediately, while a smaller amount are passed on to an internal procedure within CRA where the tax payer can object and have the reassessment reviewed. The percentage of objections granted since 2006 has varied from as low as 25% to as high as 49%.<sup>6</sup>

After the internal procedure, the taxpayer can appeal to the Tax Court of Canada. While the number of these cases may not be statistically robust, the percentage of appeals granted in favour of the tax payer has varied from as low as 32% to as high as 52%.<sup>7</sup>

In summary, there is less than a 1% chance that a tax payer will be successfully reassessed by CRA under general circumstances.

The second element in evaluating the risk of engaging in sophisticated tax planning is the amount of the settlement payment to CRA. Under normal circumstances, where a tax payer has engaged in legitimate planning on the specific advice of a professional advisor no penalties should apply. Although CRA and the Department of Justice publicly state that settlement terms must formally adhere to the *Income Tax Act*, (i.e. meaning the application of interest on taxes owed), practically speaking there are ways to apply legislative provisions in such a way as to effectively reduce the amount owed to absorb the concept of interest. In other words, it is possible for CRA to settle on the basis of simply recouping the original taxes owed.

Keep in mind too that there exists time limitation provisions in the *Income Tax Act*, such that CRA are barred from reassessing a tax filing. Generally, the time limitation is three years from the date of receipt of the original assessment notice.

In summary, the amount potentially owed could very well be the taxes payable without doing the planning. Therefore, the only “at risk” capital would be the cost of establishing the plan itself and this would only be at risk until the statute of limitation period has been reached.

*What is the gain?*

The gain is the potential tax savings. Therefore, plans should focus on areas where extraordinary gains can be accomplished, such as regular income, dividends and possibly capital gains. Sheltering investment income (especially on conservative portfolios) is less desirable.

*Other elements of Tactical Tax Planning®*

In addition to the evaluation of the risk and reward, there are other elements to Tactical Tax Planning that will help make the planning more defensible.

First and foremost, all plans must be based on a fair interpretation of the *Income Tax Act* and a tax opinion addressed directly to the client that fairly represents his or her fact pattern and the plan to be implemented must be obtained. Having a written opinion protects the client from penalties under normal circumstances and allows the taxpayer access to the limitation defenses.

Second, all tax plans must have a purpose in estate, investment or asset protection planning for which they are created in addition to the tax benefit gained. The use of an additional purpose helps to insulate the tax benefits, especially in relation to a GAAR challenge.

Third, no plan should be implemented that uses synthetic transactions. Synthetic or “Black Box” planning is planning that has no logical basis. Even planning that incorporates transactions that are based on non-commercial terms (such as unrealistic interest rates) should be avoided.

Fourth, stay away from plans that are politically sensitive (charitable donation schemes and RSP strips for example), or create deductions greater than cash expended (some of the film and software limited partnership plans have been structured in this fashion). These types of plans are the target of special CRA initiatives.

Lastly, none of the planning engaged in should require specific identification with or authorizations from the government.

## **CONCLUSION**

What if someone were to give you \$1M? (This represents your tax savings) And what if there was less than a 1% chance that you would have to repay the \$1M? (This represents the probability of audit and reassessment generally in Canada) And what if after 3-4 years the person giving you the \$1M couldn't ask for it back? (This represents the federal statute of limitations on reassessments). And finally, what if, in the event that you were asked to pay back the \$1M, there were no penalties or interest charges levied? (This represents the typical terms of a majority of settlements for most legitimate tax plans reassessed by CRA). Would you take someone up on this gift?

Tactical Tax Planning® is the concept of quantifying the downside of tax planning as the cost to create and implement the plan itself. It is not about having to pay the taxes that you would have paid in the first place. If the cost is low enough relative to the expected savings, then a client can get a clear picture of his or her risk.

Despite the fact that most tax advisors like to focus on just the plan itself, the total environment of tax planning is also relevant. Would a competent investment advisor speak to a client only about the merits of a specific security without addressing historical returns or movements in the market as a whole? Not likely. In fact, most high net worth discretionary asset managers focus primarily on asset allocation based on historical market returns and usually leave specific security picks to third party managers.

Finally, a taxpayer should also have the right to feel secure when engaging in legitimate planning, regardless of the amount of tax savings involved. They should not have to fear the government's reluctance to the loss of potential tax dollars. Although the principle in *The Duke of Westminster* may never have been absolute, it should be the foundation on which a Canadian taxpayer may rely.

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<sup>1</sup> See Appendix A, "A Fertile Ground for Tax Planning".

<sup>2</sup> For the purposes of this paper "High Net-Worth Individuals" are defined as those individuals having in excess of \$1,000,000 in net investible assets, NOT including their primary residence. We would also include individuals earning \$100,000 per year or more, in excess of funds required to meet day to day living expenses.

<sup>3</sup> Organization for Economic Cooperation and Development.

<sup>4</sup> See Appendix D.

<sup>5</sup> Sheppard, Judi, "Canada Revenue Agency – The Regulatory Environment". A paper prepared for the Society of Trust and Estate Practitioners (Toronto Branch) Continuing Education Passport Program May 11, 2010.

<sup>6</sup> ATIP Request A-049326

<sup>7</sup> Ibid.

## APPENDIX A

### A FERTILE GROUND FOR TAX PLANNING

#### *Increase in High Net-Worth Individuals in Canada*

According to Statistics Canada, the number of HNWI's in Canada has increased five-fold over the last 25 years.<sup>8</sup> This level of increase in the upper middle class is typical of most western nations over the same period. The total number of HNWI's is calculated by a multinational consulting group called Capgemini, which collaborates with Merrill Lynch to author an annual World Wealth Report. As of 2010, Capgemini and Merrill Lynch estimated that there were approximately 250,000 HNWI's in Canada,<sup>9</sup> and if you looked at households (two or more income earners) instead of individuals, the Globe & Mail estimates that there would be a total of 500,000 HNW households in Canada.<sup>10</sup>

#### *Surges in Globalization and Technology*

Since 1950, global trade as a percentage of World GDP has gone from approximately 7% to 25%, which has resulted in an unprecedented movement of capital and people around the world.<sup>11</sup> Most of this has happened in the last 20 years. The dramatic increase in international trade has also been part of the reason for the exponential increase in individual wealth in the western world.

Simultaneously, the globalization trend has provided opportunities for HNWI's (including Canadians) to use low tax jurisdictions for planning. World trade has opened employment opportunities for white collar professionals in jurisdictions such as Bermuda, Cayman and many other no or low tax jurisdictions, which when combined with the advances in technology (including internet banking, emails and VOIP), there has spawned pods, or nodes, of tax planning and asset protection niches around the globe.

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<sup>8</sup> This estimate was based on net worth and net income statistics for Canadians in the following documents, "A Profile of High Income Canadians 1982 to 2004", by Brian Murphy, Paul Roberts, Michael Wolfson (Statistics Canada - Minister of Industry Canada), September, 2007; "Federal Personal Income Tax: Slicing the Pie", by Patrice Martineau (Statistics Canada – Minister of Industry Canada), April, 2005; "The Wealth of Canadians: An Overview of the Results of the Survey of Financial Security 2005", (Statistics Canada – Minister of Industry Canada), December, 2006; "The World Wealth Report 2009", by Capgemini and Merrill Lynch Global Wealth Management; and "The World Wealth Report 10<sup>th</sup> Anniversary Edition 1997-2006" by Capgemini and Merrill Lynch Global Wealth Management.

<sup>9</sup> "The World Wealth Report 2009", by Capgemini and Merrill Lynch Global Wealth Management, p.5.

<sup>10</sup> McLean, Catherine, "The Million Dollar Club", Globe & Mail, February, 26, 2010, with reference to the Ipsos Reid "The Affluent Canadians Report 2009".

<sup>11</sup> "The Gains in International Trade", Timothy Taylor, *Economics*, 3<sup>rd</sup> Ed., (The Teaching Company: 2005).

## APPENDIX B

### ***THE EVOLUTION OF TAX ADMINISTRATION IN CANADA- AND WHY IT'S IMPORTANT TO UNDERSTANDING TODAY'S PLANNING OPPORTUNITIES***

Before World War I there was no income, capital gains or dividend tax in Canada. Government revenue was generated primarily from customs duties and tariffs. After income tax was enacted, wealthy Canadians began to avoid tax on their investment income by incorporating offshore companies and establishing international trusts in jurisdictions such as Monaco, Bermuda and the Bahamas.

In 1972, the Trudeau government introduced rules to tax wealthy Canadians on their offshore investment income. These were generally known as the Foreign Accrual Property Income rules, but there were a number of loop holes in these regulations that lawyers continued to plan around.

With the increase in middle class wealth and a need to plug loop holes in both domestic and international planning, the Mulroney government introduced the General Anti-Avoidance Rule (“GAAR”) in 1988, which is a provision in our laws that deems certain types of planning to be against public policy, even though it meets the technical provisions of the *Tax Act*. Given that GAAR could be used in the extreme to counteract legitimate tax planning, it has been used sparingly by the government and closely scrutinized by the courts.

In the 1990's, Chretien's government introduced tax identification regulations for tax products and new legislation to deal with non-resident trusts and companies.

This was followed in the 2000's by the enactment of penalty provisions for professional advisors (such as lawyers and accountants) for negligent tax advice and the establishment by CRA of an “Aggressive Tax Planning Unit” to help identify and administer both legitimate and illegitimate tax plans engaged in by taxpayers.

Now, the Harper government has invited a number of governments from non-taxing jurisdictions to enter into Tax Information Exchange Agreements and has made a proposal to codify the concept of “Aggressive Tax Planning”, which would make tracking certain planning and having a chance to reassess it much easier. Any tax avoidance transaction that contained two out of any three of the following hallmarks, would require identification to the government for immediate evaluation: 1) plans providing for contingency fees payable to the professional advisors, 2) plans which are subject to a confidentiality agreement or, 3) plans that provide for contractual protection regarding fees or some other element of benefit to the client, should the plan be reassessed.

So why is the government moving in the direction that it is? First and foremost, they desperately need the revenue. Second, there is a dramatic increase in the size and value of the middle class to Canada's tax base. Third, elements exist in terms of technology, legislation, service providers and products that will allow HNWI's to engage in effective and legitimate tax planning. Fourth, it is better for the government to legislate general prohibitions and count on reporting requirements and advisor penalties, all to send a chilling effect over planning, rather than to try to combat potential planning with specific legislative prohibitions.

However, the downside to the steady increase in the complexity of the *Tax Act* and the number of reports requisitioned by the government might be that audit rates will drop. This has been the experience in the United States, which has been the leader in tax administration by deterrence.

## APPENDIX C

### THE EVOLUTION OF TAX ADMINISTRATION GLOBALLY- AND WHY IT'S IMPORTANT TO UNDERSTANDING TODAY'S PLANNING OPPORTUNITIES

In addition to individual national responses to the evolution of tax administration, there have been coordinated responses by western-based supra-national bodies, such as the European Union, the Organization for Economic Cooperation and Development (“OECD”) and most recently the Joint International Tax Shelter Information Centre. Of all of the supra-national bodies, the OECD has been the most influential so far.

The OECD was created after World War II to help coordinate rebuilding efforts in Europe. It is headquartered in Paris, France and its members now include 31 nations from around the world. Its mission is to support democracy and the free market economy. It has been an ardent opponent of low tax and no-tax jurisdictions.

The OECD started its opposition to tax havens with the creation of the Financial Action Task Force (FATF), which was reportedly created to combat money laundering connected to the international drug trade. With the support of the Clinton administration in the late 1990's, the OECD started pushing the envelope to include what it termed “unfair” or “harmful” tax practices, with its 1998 report “Harmful Tax Competition, An Emerging Global Issue.”<sup>12</sup> In the Report, the OECD recommended establishing a “black list” of countries that it deemed (in its sole discretion) discriminated against the free market principles of its member countries.

With the change of administration in the United States from Democratic to Republican under George W. Bush and the staunch resistance from certain international centres (most notably Barbados), the OECD backed off from its initiative for the time being. It instead, morphed the FATF into a more active role after 9/11, by including terrorism as one of the proponents of money laundering and therefore was able to increase the visibility and support for FATF. This in turn led to an exponential increase in due diligence requirements forced on the tax havens, which although a good thing, was simply a screen for the OECD's underlying tax policies.

With the end of the Bush administration and the advent of the new Democratic era under Obama the OECD was set loose once more. The change in US attitude towards tax havens was vociferously announced with the Obama/Levin sponsored “*Stop Tax Haven Abuse Act*” and the simultaneous attack on UBS.

This “Call to Arms” led to an immediate G20 summit on April 2, 2009 (headed by the UK's Gordon Brown) and a second round of tax haven denouncements primarily orchestrated once more by the OECD. Since then, the international finance centres have again rallied (this time

much more quickly given their previous experience) and they have agreed with western nations to sign a host of Tax Information Exchange Agreements (“TIEA’s”), which now seems to have set the standard for a balance between no/low tax jurisdictions and the OECD member states, together with a trend towards lower taxes amongst the G8<sup>13</sup>.

Although the OECD has been successful in forcing a technical means for administrative disclosure in previously secretive jurisdictions, this will only stop tax evasion vis-à-vis the use of secret bank accounts. Real tax planning should be unaffected by information exchange.

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<sup>12</sup> <http://www.oecd.org/dataoecd/33/0/1904176.pdf>

<sup>13</sup> “Promoting Transparency and Exchange of Information for Tax Purposes”, June 28, 2010.  
<http://www.oecd.org/dataoecd/32/45/43757434.pdf>

## APPENDIX D

### ***WHAT'S THE DIFFERENCE BETWEEN TAX PLANNING, TAX AVOIDANCE, AGGRESSIVE TAX PLANNING AND TAX EVASION?***

Generally speaking, tax evasion is a transaction entered into by a taxpayer that includes false expenses or requests for false tax credits, or where the taxpayer has failed to report income that he or she knew was earned.

Tax avoidance (where used in an “abusive” context) generally means tax planning that meets the technical provision of the *Tax Act*, but not the “spirit” of the law. This type of planning is usually characterized by non-commercial or “synthetic” transactions.

Aggressive tax planning is currently being defined as planning that includes elements of secrecy and results oriented remuneration to the professionals involved or protection for the client.

Legitimate tax planning can generally be characterized as planning that includes commercially viable transactions that are based on a “fair” or “reasonable” interpretation of the *Tax Act*.