

# Evasion or Avoidance: A Crucial Difference

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The old adage, "an ounce of prevention is worth a pound of cure" is particularly true when you are dealing with the tax man.

Although this article assumes that the reader/taxpayer is a Canadian resident, is subject to the Income Tax Act ("ITA") and will be dealing with the Canada Revenue Agency ("CRA") similar principles may cautiously be applied to other common law jurisdiction like the U.S.A. and England.

Taxing statutes are some of the most complex written documents known to mankind; so expert accounting and legal advice is needed to avoid their many pitfalls.

This article is designed to alert the reader to the concerns that should to be addressed before structuring, or restructuring, your business affairs or engaging in a tax reduction strategy you heard was 'great.'

## Evasion Versus Avoidance

Evasion is an offence under §239(1)(d) of the ITA and unlike the enforcement provisions creating civil penalties (§§162 – 163 ITA), or regulatory offences (§238), evasion is a true criminal offence: *R. v. Knox Contracting Ltd.*, [1990] 2 S.C.R. 338 at 346-348 and *R. v. Klundert* (2004), 242 D.L.R. (4th) 644 per Doherty, J.A. at §32.

Avoidance is structuring your affairs to minimize or defer taxes without violating the provisions of the ITA, however, is not a crime (*Hickman Motors Ltd. v. Canada*, [1997] 2 S.C.R. 336 McLachlin J. at §8).

## Structuring Your Affairs

It is a fundamental principle of tax law that "[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be": *Inland Revenue Commissioners v. Westminster (Duke of)*, [1936] A.C. 1 (H.L.), at p. 19, per Lord Tomlin.

As Wilson J. put it in *Stuart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536 (S.C.C.), at p. 540, "[a] transaction may be effectual and not in any sense a sham (as in this case) but may have no business purpose other than the tax purpose".

## Tax Policy

Some so-called loopholes in the ITA are actually provisions designed to achieve a particular policy objective for Parliament.

One kind of behaviour may be thought to be beneficial and it is given a preferential tax treatment (e.g., tax shelters) while another may be considered detrimental to public policy objectives or revenue generation and it is subject to a higher level of taxation (e.g., §219 ITA). It is the complexity of these competing interests which help make income tax as complex as it is.

It is imperative that any taxpayer, who wants to structure their affairs to achieve a particular benefit, should consult their tax accountant and/or their tax lawyer to get expert advice before they do anything.

Your situation is unique and so too is the solution to your circumstances – there is no substitute for expert advice tailored for you. For large transactions your tax advisers may even recommend obtaining an advance tax ruling from CRA (see Information Circular IC 70-6R).

## ITA: A Code

The Income Tax Act is designed to be a complete code; that is, if you fall inside its provisions you will be subject to its terms as dictated by Parliament, but if you fall outside its provisions you are free of its strictures.

The ITA taxes on residency (§2(1) ITA) and source of income (e.g., §§5 and §9(1) ITA) so usually if you are a non-resident (not carrying on business in Canada; e.g., §§2(3)(b) and §253) you are subject to taxation here. Similarly, if your receipt of funds is not attributable to a prescribed source (e.g., lottery winnings or gifts) then you are not tax on those receipts.

Here is a caveat for our American readers: the IRS taxes on residency and on citizenship; they also tax 'windfalls' like your winnings in Las Vegas; and 'gifts' may be subject to both federal and state taxes.

The theory is generally the same, if you're in the Act you pay, and if you're out of the Act, you don't. It is this clear demarcation, which permits, tax planning (cf., *Hickman Motors Ltd.*, above).

The theory, however, is subject to some complications. Under Part XVI of the ITA, after September 13, 1988 §245(2) provides a general anti-avoidance rule ("GAAR") which was designed to prevent abusive tax avoidance. It is an anti-avoidance provision of last resort: *Canada v. Imperial Oil Ltd.*, [2004] 2 C.T.C. 190 per Coram at §30.

"Tax minimization is legal and acceptable; abusive tax avoidance is not": Vern Krishna, *The Fundamentals of Canadian Income Tax*, 7th ed. (Toronto: Carswell, 2002) at 868.

Put this into vernacular CRA is saying that if you're clever enough to come up with a plan Parliament didn't think of (that is, one that doesn't offend a specific anti-avoidance provision), it costs the government too much money in tax revenues, and CRA thinks you did only to avoid paying taxes, they will try to claw it back. Whether the courts permits this, will depend on the facts.

If the scheme considered in the *Duke of Westminster* was used in Canada today it "would probably be caught" by GAAR: Hogg, Magee and Li, *Principles of Canadian Income Tax Law*, 4th ed. (Toronto: Carswell, 2002) at 584. GAAR, however, is not a criminal provision in the ITA.

The Offence Of Evasion: §239(1)(d) ITA

As with all such questions it is necessary to begin with the statutory language: "every person who has ... (d) wilfully, in any manner, evaded or attempted to evade compliance with this Act or payment of taxes imposed by this Act ... is guilty of an offence ..." it is apparent that there are two constituent elements for committing this offence:

\* proof of an act or course of conduct (the "actus reus") which has the effect of evading or attempting to evade payment of taxes actually owed under the Act (Klundert, above, §34); and

\* a culpable state of the taxpayer's mind (the "mens rea"). The conduct component can usually be established where tax is owed under the ITA and the taxpayer has failed to report, calculate and pay the applicable tax owing (Klundert, §42).

The fault or mental component is found in the word "wilfully": *R. v. Docherty* (1989), 51 C.C.C. (3rd) 1 (S.C.C.) What will be required is something more than "negligently" or even "recklessly".

Culpability will then follow only where the accused engages in conduct intended to avoid the payment of tax owing under the Act; that is, the accused must know that the tax is owing under the ITA and they must intend to avoid payment of the tax (Klundert, §46).

Mistakes of fact can negate the fault requirement for the offence (e.g., arithmetic errors) but purely legal errors usually won't (e.g., §19 Criminal Code, "CC"). Discuss with your lawyer whether any mistakes of fact, or law, you may have made provide you with a defence to the charge(s). Each case will resolve itself based on its own set of facts.

Tax Planning

There is a "need to distinguish between legitimate tax planning and the crime of tax evasion" (Klundert, §36).

It is the culpable state of mind (i.e., mens rea) that distinguishes the legitimate tax planner from the dishonest tax evader. Both may engage in the same course of conduct that can aptly be described as a deliberate attempt to avoid payment of tax. The difference lies in their respective states of mind. Unlike the tax evader, the tax planner does not intend to avoid the payment of a tax that he or she knows is owed under the Act, but rather he or she intends to avoid owing tax under the Act in the first place (Klundert, §41).

Section 239(1)(d) is part of an Act which is necessarily and notoriously complex. It is subject to ongoing revision. No lay person is expected to know all the complexities of the tax laws. It is accepted that people will act on the advice of professionals and that the advice will often turn on the meanings to be given to provisions in the Act that are open to various interpretations. Furthermore, it is accepted that one may legitimately structure one's affairs so as to minimize tax liability (Klundert, §55). In other words, if you retain and follow professional advice then it is unlikely you will be charged with tax evasion; or if charged, that you will be convicted.

So essentially we're back to where we began, "an ounce of prevention is worth a pound of cure." Staff Writer  
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