

ACCESS TO JUSTICE IN INCOME TAX APPEALS

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INTRODUCTION – JURIDICAL VS. ECONOMIC BARRIERS

This article considers barriers which may hinder access to the judicial process by taxpayers who seek to challenge assessments of income tax. It is limited to appeals relating to the personal and corporate income imposed by the federal Parliament and administered by the Canada Revenue Agency (CRA), or the corresponding taxes imposed by the provincial and territorial legislatures and administered by the CRA under tax collection agreements.¹

Access to justice may be impeded either by juridical or economic factors; the relevant law and judicial processes may prevent or only provide substantively or procedurally limited avenues of appeal. Alternatively, the legal process may be adequate but the cost of using the appeal procedures may effectively prevent or discourage access. A brief review of the appeal mechanism available to a taxpayer in respect of an income tax assessment reveals that there are no material juridical barriers. The discussion therefore focuses on economic barriers and seeks to identify ways in which the barriers might be reduced.

The Income Tax Appeal Process

Income tax is imposed by the relevant statutory charging provision but generally only becomes payable when an assessment is raised by the CRA, using the statutory powers conferred on the Minister of National Revenue.² Under the *Income Tax Act*,³

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¹ CRA administers provincial and territorial personal income taxes for all provinces except Quebec and corporate income taxes for all provinces and territories except Quebec and Alberta. The Quebec personal and corporate income tax are administered by Revenu Quebec; the appeal procedures applicable to them and the access to justice issues arising are not materially different from those discussed here. The same is true for the administration of the Alberta corporate income tax.

² This issue is discussed in my article, "Liability for the Tax on SIFT Partnerships: A Rejoinder", *Canadian Tax Journal*, (2011), 59:4.

³ *Income Tax Act*, RSC 1985, c 1 (5th Supp.), as amended [ITA].

a taxpayer has an absolute right to challenge an assessment by filing an objection with the CRA. Except for large corporations, there are no demanding technical requirements and there are no filing fees. The taxpayer need not retain legal or other professional advice, though may choose to do so. Objections are considered by the appeals branch of the CRA in what is a non-judicial⁴ internal administrative review. If the result of that review is not satisfactory to the taxpayer,⁵ there is an absolute right of appeal to the Tax Court of Canada.⁶

The Tax Court offers two different procedures, or “tracks” for an appellant taxpayer: the Informal Procedure (IP), which closely resembles a typical small claims court format; and the General Procedure (GP), which is substantially identical to the procedure for trials in the Federal Court or the provincial superior courts.⁷

Thus, there are no pre-trial discoveries, either oral or of documents, under the IP and the court is not bound by “legal or technical” rules of evidence. The taxpayer, if not self-represented, can be represented at an IP appeal by a non-lawyer agent such as an accountant. Like small claims courts, the jurisdiction of the Tax Court in IP appeals is defined by monetary limits. If the amount of federal tax or penalty in issue in a year exceeds \$12,000 or the amount of a loss in issue exceeds \$24,000⁸ the appeal must either be dealt with under the GP or the taxpayer must abandon the excess. The Crown can effectively move an appeal otherwise falling under the IP to the GP when: the amount of interest exceeds \$12,000, if the outcome of the appeal will affect other appeals, if the reassessment of the taxpayer and the total federal tax in issue exceeds \$12,000, or if the appeal is common to a group or class of persons. The taxpayer who is unsuccessful in an IP appeal is only exposed to costs if the taxpayer unduly delays resolution of the appeal. However, if more than 50% successful, the taxpayer may receive costs (in respect of counsel only) on a party and party tariff basis. For a typical IP appeal such costs would be approximately \$800.

⁴ Though subject to judicial review for procedural fairness.

⁵ Most objections are disposed of at this level, but it is difficult to know how many are decided on their merits and how many are abandoned or compromised by taxpayers because of reluctance or inability to pursue them further, whether on financial or other grounds.

⁶ Subject only to non-substantive requirements of timing and form.

⁷ See sections 17 through 18.302 of the Tax Court of Canada Act, RSC 1985, c T-2 (as amended), and the Rules made thereunder. The Tax Court GP Rules are substantially similar and sometimes identical to the rules of procedure in the provincial superior courts or the Federal Court.

⁸ With the exception of Quebec income taxes, and the Alberta corporation income tax, the appeal of a federal tax assessment includes an appeal of the provincial or territorial tax on the same income. Because, for an individual, such tax is typically about 50% of the federal tax, the upper limit on access to the IP (without abandoning any excess) is total tax of about \$18,000. For a corporation the corresponding amount would be about \$20,000.

The unsuccessful taxpayer in a GP appeal is exposed to costs in the same way as an unsuccessful litigant in a provincial superior court or the Federal Court. The only concession made to appeals involving smaller amounts in the GP is to dispense with oral examinations for discovery where the amount of federal tax in issue in a year is less than \$25,000 or the loss in issue is \$50,000 or less. Costs in the GP are normally awarded to the successful appellant on a party and party tariff basis. For an appeal involving up to \$100,000 of federal tax, such costs typically would be about \$4,000, to which must be added disbursements and any expert witness fees. In the GP, the taxpayer, if not self-represented, must retain legal counsel.

Appeals from decisions of the Tax Court lie to the Federal Court of Appeal and do not require leave of either the Tax Court or the Federal Court of Appeal. The appeal procedure is the same as that employed for appeals from the Federal Court. Appeals from the Federal Court of Appeal lie to the Supreme Court of Canada, with leave. Taxpayers who are unsuccessful in the Federal Court of Appeal face the usual exposure to an award of costs to the successful party. At each stage of the judicial process, therefore, the appellant taxpayer has access, without legal or regulatory restriction, to courts staffed with impartial and skilled judges, highly professional competent administrators, procedural rules designed to safeguard a litigant's interests and rights as sophisticated as in any other judicial process in Canada. It is accordingly difficult to identify any meaningful juridical barriers to justice in income tax appeals in these circumstances. A review of the economic barriers to justice in this area, however, reveals a more uncertain position.

Economic Barriers

Assessment of economic barriers to justice in income tax appeals is complicated by the fact that there are, to the author's knowledge, no empirical studies which attempt to measure the degree to which taxpayers are deterred from pursuing their appeal rights because of the costs involved. The approach taken here is to analyze a number of different scenarios involving different amounts of tax in issue. We begin by measuring the likely cost of an appeal, including taking into account the deductibility of appeal costs,⁹ and compare it to the likely benefit to the taxpayer in the form of reduced tax, interest or penalties. We also take into account the risk that the taxpayer will be required to pay costs if the appeal is unsuccessful and the opportunity to recover costs if the appeal succeeds. It is assumed that when the cost – the potential 'downside' – exceeds a certain percentage of the potential 'upside' benefit, that cost will have a material deterrent effect on the taxpayer. The analysis which follows is limited to the trial level but an appeal to the Federal Court of Appeal will further raise the cost and financial risk to a taxpayer appellant.

⁹ Section 60(o) of the *ITA* allows the deduction in computing income of fees or expenses relating to an income tax appeal, including at the objection stage. *ITA*, *supra* note 4, s 60(o).

Costs of a Tax Court Appeal

Some of the costs – filing fees or costs awarded to the successful party under the tariff - are relatively known factors. Other costs to a taxpayer of pursuing a Tax Court appeal are more difficult to estimate, but based on the author's experience and discussions with experienced tax counsel, estimates can be made which help to define the parameters.

(A) Time Spent

Estimating the time required to deal with any piece of litigation is notoriously difficult, and tax litigation is no exception. It is partly a function of the complexity of the issue, the volume of evidence to be presented, the length of examinations for discovery and the manner in which opposing counsel approach the case. For a GP appeal of average complexity, a reasonable estimate might, however, be 80 hours of counsel time. For a GP appeal with less than \$25,000 federal tax is issue and therefore no examinations for discovery, this might be reduced to 60 hours. For an IP appeal, the task of estimating is further complicated by the fact that virtually no tax lawyers take on IP appeals (other than on a pro bono basis or as a favour to a client) because the limited amounts at stake would rarely if ever justify the expense. For these purposes I have estimated 20 hours of counsel or agent time.

(B) Hourly Rates

The estimate of hourly rates must take into account the fact that an appeal may require the services of either or both more and less senior counsel, as well as articling students. If an agent is used for an IP appeal rather than counsel, the cost of services would normally be lower. A reasonable estimate for the hourly rate of tax counsel of \$600 per hour is used. In many cases, this rate will be higher. For an agent \$200 per hour may be a reasonable estimate.

(C) Fees and Disbursements

A reasonable estimate for filing fees and disbursements, other than expert witness fees but including discovery costs in a GP appeal, would be about \$2,500.¹⁰ Where an expert witness, such as an accountant, is required, it is unlikely that the cost to the taxpayer or the Crown, as the case may be, would be less than about \$5,000, and in most cases would be higher. For an IP appeal, fees and disbursements are unlikely to exceed about \$500.

¹⁰ When there are no oral discoveries, I have estimated \$1,500.

(D) Tax Effect

Section 60(o) of the *ITA* allows a taxpayer to deduct the fees and expenses relating to an income tax appeal in computing income. Consequently, the burden of such expense on the taxpayer must be reduced by the value of the deduction, calculated by multiplying the expense by the taxpayer's marginal tax rate. I have assumed an individual taxpayer with an income of approximately \$100,000, implying a combined federal and provincial marginal tax rate of approximately 40%. For a corporate taxpayer, the tax rate would vary from about 15%, in respect of income eligible for the small business credit under s. 125 of the *ITA*, to 25% for other business income and approximately 46% for income subject to the refundable tax regime. Thus, there would generally be less benefit to a corporation from tax affecting the cost of tax litigation and higher after-tax cost because the lower marginal tax rate produces a lower deduction.

COST-BENEFIT ANALYSIS

The cost/benefit analysis, which follows, has been carried out as follows:

1. Determine the tax and interest in issue and the cost incurred by the taxpayer using the assumptions above.
2. Determine the portion of the expenses which would be recovered if the appeal is successful and deduct it from the costs otherwise incurred.
3. Determine the after-tax cost to the taxpayer by multiplying the net costs by the assumed marginal tax rate (40%) and subtracting the product from the net expenses.
4. Determine the ratio of the cost determined under 3 to the benefit (the tax and interest determined under 1) by dividing the cost by the benefit.
5. Determine the additional cost if unsuccessful, add that amount to the expenses determined under 1 and determine the after-tax cost by multiplying the total by the marginal tax rate and subtracting the product from the total expenses.
6. Determine the after-tax cost of the appeal if unsuccessful by dividing the amount determined under 5 by the benefit.

Case 1:

Tax in Issue	\$30,000
Interest	<u>4,500</u>
	\$34,500

Expenses

Counsel – 60 hrs. @ \$600 =	\$36,000
Disbursements	1,500
Expert Witness	<u>5,000</u>
	\$42,500

Recovery of expenses if successful

Party and party costs	\$ 4,000
Disbursements and witness fees	<u>6,500</u>
	\$10,500
Net expenses	\$31,000
After-tax	\$18,430
Cost: Benefit – 54%	

Additional expense if unsuccessful

Party and party costs	\$ 4,000
Disbursements and witness fees	<u>6,500</u>
	\$10,500

After-tax cost of pursuing the appeal if unsuccessful - \$32,800 (95% of amount at stake)

Case 2

Tax in Issue	\$60,000
Interest	<u>9,000</u>
	\$69,000

Expenses

Counsel – 80 hrs. @ \$600 =	\$48,000
Disbursements	2,500
Expert Witness	<u>5,000</u>
	\$55,500

Recovery of expenses if successful

Party and party costs	\$ 4,000
Disbursements and expert witness fees	<u>7,500</u>
	\$11,500
Net expenses	\$44,000
After-tax expenses	\$26,400
Cost: Benefit – 38%	

Additional expenses if unsuccessful

Party and party costs	\$ 4,000
Disbursements and witness fees	<u>7,500</u>
	\$11,500

After-tax cost of pursuing the appeal if unsuccessful - \$40,200 (58% of amount at stake)

Case 3

Tax in Issue	\$100,000
Interest	<u>15,000</u>
	\$115,000

Expenses

Counsel – 60 hrs. @ \$600 =	\$30,000
Disbursements and fees	2,500
Expert Witness	<u>5,000</u>
	\$55,500

Recovery of expenses if successful

Party and party costs	\$ 4,000
Disbursements and expert witness fees	<u>7,500</u>
	\$11,500
Cost: Benefit – 23%	

Additional expenses if unsuccessful

Party and party costs	\$ 4,000
Disbursements and witness fees	<u>7,500</u>
	\$11,500

After-tax cost of pursuing the appeal if unsuccessful - \$40,200 (35% of amount at stake)

IP AppealsCase 4:

Tax in Issue	\$18,000
Interest	<u>2,700</u>
	\$20,700

Expenses

Counsel – 20 hrs. @ \$600 =	\$12,000
Disbursements	\$ 500

Recovery of costs if successful	\$800
Net expenses	\$11,700
After-tax expenses	\$ 7,020
Cost: Benefit – 34%	

After-tax cost of pursuing the appeal if unsuccessful - \$7,500 (36% of the amount at stake).

Case 4A:

Tax in Issue	\$18,000
Interest	<u>2,700</u>
	\$20,700

Expenses

Agent – 20 hrs. @ \$200 =	\$4,000
Disbursements	\$ 500
Recovery of costs if successful	\$800
Net expenses	\$3,700
After-tax expenses: \$2,220	
Cost: Benefit – 11%	

After-tax cost of pursuing the appeal if unsuccessful - \$2,700 (13% of amount at stake)

Case 5:

Tax in Issue	\$30,000
Interest	<u>4,500</u>
	\$34,500

Expenses

Abandon excess	\$ 8,000
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Counsel – 20 hrs. @ \$600	\$12,000
Disbursements	\$ 500
Recovery of costs if successful	\$ 800
Net expenses	\$11,700
After-tax cost	\$15,020
Cost: Benefit:	44%

After-tax cost of pursuing the appeal if unsuccessful - \$15,500 (45% of amount at stake)

Case 5A:

Tax in Issue	\$30,000
Interest	<u>4,500</u>
	\$34,500

Expenses

Abandon excess	\$ 8,000
Agent – 20 hrs. @ \$200	\$ 4,000
Disbursements	\$ 500
Recovery of costs if successful	\$ 800
Net expenses	\$ 3,700
After-tax cost	\$10,220
Cost: Benefit –	30%

After-tax cost of pursuing the appeal if unsuccessful - \$10,700 (31% of amount at stake)

DISCUSSION

While this analysis is necessarily imprecise, it is evident that there exists a "cost trap" in the income tax appeal process which likely constitutes a significant disincentive to pursue appeals beyond the challenge to a CRA assessment stage. It is unlikely that a taxpayer will pursue a small GP appeal where the after-tax cost ranges

from 23% (Case 3) to 54% (Case 1) of the amount recoverable in the event of complete success and the cost if unsuccessful ranges from 35% (Case 3) to 95% (Case 1) of the amount in issue. It must be remembered also that the estimates used here are fairly conservative and, in any case, are only estimates. Once an appeal is launched, the taxpayer has relatively little control of the cost and may be placed in a position where the only way to control costs is to abandon the appeal.

For IP appeals, the cost:benefit ratios are more favourable, particularly where the amounts are sufficiently small that no excess must be abandoned and an agent is used (Case 4A). In these appeals the after-cost to the taxpayer if unsuccessful is 36% of the amount at stake where counsel is used, or 13% if an agent is used. Not surprisingly, few appellants in IP appeals are represented by counsel, and many are self-represented. This not only prejudices their claims of a fully effective review the merits of the case but places a significant burden on judges who are forced to assist, in the interest of fairness, those appellants in presenting their case in accordance with the requirements of the IP Rules.

For taxpayers with sufficient amounts in issue as to be in the GP, agents cannot be used and the cost of counsel is an obvious deterrent to access to the court. It is obvious that the costs of taking tax appeals involving smaller amounts are a significant deterrent to lower and middle income taxpayers and thus act as a real barrier to access to the justice system for such taxpayers. In the remainder of this article, I will consider ways in which this situation might be alleviated.

Some Suggestions to Improve Access to Justice in Tax Appeals

(A) Broader Access to the Informal Procedure

The monetary limit for access to the IP was set at \$7,000 of federal tax in issue (or \$14,000 of losses) in 1991 and increased to \$12,000 (or \$24,000 in losses) in 1993. To reflect inflation and to broaden access to the cheaper IP, the threshold should be raised to at least \$25,000 of federal tax in issue (or \$50,000 of losses).¹¹ This would reduce the cost:benefit ratio in Case 5 from 44% to 20% when using counsel or from 30% to 6% if an agent were used. If the threshold were increased to \$50,000, the cost:benefit ratio for Case 2 would decline from 38% to 8% using an agent or to 35% using counsel.¹² These changes are overdue and should be proceeded with.

¹¹ As proposed in: Department of Finance, News Release, 2011-116, "Government Invites Comments on Proposals to Improve the Caseload Management of the Tax Court of Canada" (10 November 2011) online: Department of Finance News Releases <<http://www.fin.gc.ca/n11/11-116-eng.asp>> [News Release].

¹² *Ibid.* The News Release also proposed to amend the Tax Court of Canada Act to allow the monetary threshold to be increased further to \$50,000 (or \$100,000 in losses) by regulation.

(B) Assistance to Taxpayers using the Informal Procedure

Consideration should be given to the provision, perhaps through the Courts Administration Service, of duty counsel or appropriately-trained paralegals to assist unrepresented taxpayers in IP appeals. An unrepresented taxpayer might be required to meet with such person prior to the hearing, who would assist the taxpayer in arranging documentary evidence, and in understanding the procedures for presenting oral evidence and argument. They might attend the hearing if requested by the presiding judge. This would help to put lower or middle income taxpayers on a more even playing field and would reduce the time spent and burden placed on judges in dealing with unrepresented litigants. The latter arguably would improve the quality of justice available to such taxpayers. Furthermore, by allowing them to acquire a basic knowledge of the process and procedure without additional cost improves their access to the justice system.

Such an approach could be complemented by provision of legal advice through student legal aid clinics or pro bono work by lawyers and the Tax Court could consider requesting the provincial law societies and the law schools to specifically encourage such activities.

(C) General Procedure

The monetary threshold for examinations for discovery in the GP should be increased to at least \$50,000 of federal tax in issue (or more depending on the threshold set for access to the IP).¹³ This would reduce the costs and complexity of such small GP appeals and should be proceeded with.

Section 30(2) of the GP Rules, which requires the consent of the court for a corporation to be represented by an agent (such as a director or shareholder) has generally been applied to allow such representation where the corporation can show financial need. Consideration should be given to making this automatic where amounts in issue fall below a certain threshold (perhaps the same threshold for waiving examinations for discovery). Such small corporations are often an alter ego for their shareholders (who are usually also directors) who should not be denied the right of self-representation merely because of the choice of corporate form to carry on a business.

¹³ *Ibid.* Also as proposed.

(D) Settlement and Mediation

Daniel Sandler and I have discussed elsewhere the obstacles to reaching pre-trial settlements in tax appeals¹⁴ arising out of the case law and the absence of any specific statutory support in the *ITA* for settlements on the basis of litigation risk or good administration. This is reflected at times in hesitation on the part of the CRA and the Department of Justice in entering into settlements. As we suggested there, this aspect of the problem can be dealt with best by an amendment to the *ITA*. The amendment would specifically empower the CRA to compromise tax disputes, which should be accompanied by an administrative policy which is settlement-friendly. That policy should be directed at reaching settlement, if at all possible, prior to the discovery stage in GP appeals, so as to minimize costs for both parties.

The Tax Court should, in this context, be commended for recent draft GP Rule amendments,¹⁵ (already effectively implemented)¹⁶ which introduce cost sanctions for refusal of reasonable settlement offers. Proposed Rule 126.3 allows the Court to call a settlement conference at any time, either on its initiative or that of a party to explore the possibility of settlement. The Court should not hesitate to use the power, preferably early in the process and particularly in the case of appeals with modest amounts at stake. In such conferences, the presiding judge should not hesitate to proactively encourage settlement. In the event that this places too great a burden on judges, or if it is felt that this detracts from their proper judicial function, consideration might be given to using experienced practitioners as mediators.

Appeals to the Federal Court of Appeal

Where a taxpayer is successful in an IP appeal or a GP appeal where the amount in issue is less than a certain threshold amount (perhaps \$50,000 to \$100,000 in federal tax) and the Crown appeals, consideration should be given to removing any cost risk to the taxpayer if the appeal succeeds. A taxpayer bringing such an appeal of an assessment in the Tax Court will already have incurred significant costs and will be forced to incur further costs in the Federal Court of Appeal to defend the victory won in the court below. While it is difficult to mitigate these costs without some sort of direct subvention to the taxpayer, at least the added risk of paying costs to the Crown if the Crown's appeal is successful could be removed.

¹⁴ See Daniel Sandler and Colin Campbell, "Catch 22: A Principled Basis for the Settlement of Tax Appeals", *Canadian Tax Journal* (2009) 57:4, pp 762-786.

¹⁵ See proposed GP Rules 147(3.1) to (3.3).

¹⁶ See Practice Note 17, dated January 13, 2010.

CONCLUSION

While there is no single answer to the paradox explored in this article – the creation of an increasingly sophisticated tax appeal mechanism paralleled by cost of access which discourages its use – measures can be taken which will at least ameliorate the problem and provide a greater measure of access to the tax appeal system of taxpayers of limited means.