with the process of determining a price for ranitidine that is reasonable in the circumstances, given that the licence agreement creates a market dynamic that would not generally arise in the open market.

Similarly, it is instructive to note that the minister chose not to question the quantum of the payments made under the licence agreement. While it arguably would not have affected the computation of Glaxo Canada's income for the purposes of part I of the Act, the payment of additional amounts to Glaxo Group under the licence agreement rather than to Adechsa under the supply agreement may have given rise to additional withholding tax under part XIII of the Act. The minister's position may have been influenced by the fact that the CRA has historically granted taxpayers some latitude in the structuring of transactions that are consistent with normal industry practice. For instance, the CRA has previously stated that it

> generally accepts business transactions as they are structured by the parties. The fact that a taxpayer has entered into a transaction with a non-arm's length non-resident party in a form that would not exist between arm's length parties does not necessarily imply that the transaction is inconsistent with the arm's length principle. This may reflect the fact that parties not dealing at arm's length operate under different commercial circumstances than do parties transacting at arm's length.[33]

Alternatively, the minister may have made the strategic decision to focus solely on the specific expenditures of Glaxo Canada that were viewed as exceeding the amounts that would have been acceptable to an arm's-length purchaser.

Ultimately, in light of the inherent challenges that arise when one attempts to apply conventional transfer-pricing methodologies to sophisticated modern transactions, it is likely that *Glaxo* is only the first in a long line of cases that will shape Canadian transfer-pricing jurisprudence.

On September 29, 2010, the minister filed an application for leave to appeal the Federal Court of Appeal's decision to the Supreme Court of Canada.

Michael Friedman and Rachel Zeliger

ZEN AND THE ART OF COLLECTING INTEREST ON DIRECTORS' TAX DEBTS

Zen v. Canada (National Revenue)
2010 FCA 180

KEYWORDS: DIRECTORS' LIABILITY ■ INTEREST ■ ASSESSMENTS

In *Zen v. Canada (National Revenue)*,[34] the Federal Court of Appeal upheld a Federal Court decision finding a corporate director liable to pay approximately $630,000 in

33 Ibid., at paragraph 43.

34 2010 FCA 180; aff'g. 2009 FC 531.

interest that had accrued over 20 years on an outstanding derivative assessment of approximately $100,000. The derivative assessment arose in respect of the director's joint and several liability for the corporation's failure to remit payroll withholdings.

At a superficial level, the case is a stark illustration of the perils of compound interest—particularly in the high-interest-rate environment of the late 1980s. More importantly, the court considered for the first time the legislative underpinnings of the minister of national revenue's practice of demanding that directors pay post-assessment interest on outstanding derivative assessments that arise in respect of a corporation's tax debts.

The court's decision to uphold the minister's tax-collection practices should promote the efficient functioning of the tax administration system. However, the manner in which the result was achieved raises questions about the appropriate allocation of responsibilities between Parliament and the courts since the legality of the minister's demand for post-assessment interest hinges on the court's interpretation of the open-ended phrase "with any modifications that the circumstances require."[35]

Background

The taxpayer, Mr. Zen, was a director of Pacific Refineries Inc. ("Pacific") from 1981 to 1986. In 1982, Pacific was alleged by the minister to be deficient in its payroll deduction remittances and was assessed accordingly.[36]

Having been unable to collect against Pacific, the minister assessed Mr. Zen for $103,463.62 in December 1986 ("the 1986 assessment"). The amount assessed included the payroll source deductions that Pacific failed to remit, penalties arising from its failure to remit, and interest that had accrued on Pacific's tax debt before the 1986 assessment. The basis of Mr. Zen's liability for the corporation's tax debts is found in subsection 227.1(1), which, subject to the limits in subsections 227.1(2) through (4), makes directors of a corporation jointly and severally liable for certain tax debts of the corporation and any interest or penalties relating thereto. Such assessments are issued under the authority of subsection 227(10), which permits the minister to issue notices of assessment, at any time, for liabilities arising from, inter alia, section 227.1.

Mr. Zen objected to the 1986 assessment, but as part of a settlement to a protracted legal battle he withdrew his appeal in January 1996. Various delays, both connected and unconnected with his application for fairness relief under subsection 220(3.1), followed over the next nine years.[37] In 2005, the minister issued five requests for information (RFI) in respect of Mr. Zen's net worth in order to determine

35 Subsection 160(2).

36 The obligation to withhold and remit is found in subsection 153(1).

37 The taxpayer's application for judicial review (*Zen v. MNR*, 2008 DTC 6343; 2008 FC 371) of the minister's decision to deny his fairness request was dismissed on the basis that the application was brought after the 30-day time limit for filing such an application.

his ability to pay his obligations under the 1986 assessment and any resulting interest.[38] In due course, the minister sought a compliance order in respect of the RFIs.[39] Although Mr. Zen paid the $103,463.62 face value of the 1986 assessment in February 2007, there remained an outstanding balance of $629,849.47 (as of May 2008), representing more than 20 years of compound interest that had accrued on the 1986 assessment.[40] Mr. Zen sought to have the RFIs set aside on the basis that he was not liable to pay unassessed interest. The Federal Court disagreed, and Mr. Zen appealed the decision to the Federal Court of Appeal.

The Decision

Establishing Liability

Mr. Zen conceded that he was jointly liable with Pacific for any interest that accrued on the unremitted payroll source deductions pursuant to section 227.1.[41] He also conceded that such interest would be payable to the minister if Mr. Zen was issued an updated notice of assessment that included interest accruing after the 1986 assessment. Accordingly, the question to be decided was whether the minister could take steps to collect interest accruing on the unpaid 1986 assessment or whether the minister was obliged to issue another notice of assessment that included the interest.

Interest on "Taxes Payable"

Mr. Zen's argument was based on the well-established principle that taxpayers are not required to pay an amount for which the Act makes them liable until the minister has issued a notice of assessment in respect of the amount.[42] A notable exception to this general principle is interest payable pursuant to subsection 161(1). The provision reads as follows:

> Where at any time after a taxpayer's balance-due day for a taxation year
>
> (a) the total of the taxpayer's taxes payable under this Part and Parts I.3, VI and VI.1 for the year

38 Pursuant to paragraph 231.2(1)(a).

39 Pursuant to section 231.7.

40 Mr. Zen's odyssey through the judicial system is more fully explained in the Federal Court's decision (supra note 37) denying his application for judicial review of the minister's refusal to grant interest relief under the fairness provisions of subsection 220(3.1).

41 Currently, subsection 227.1(1) reads as follows:

> Where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or 135.1(7) or section 153 or 215, has failed to remit such an amount or has failed to pay an amount of tax for a taxation year as required under Part VII or VIII, the directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay that amount and any interest or penalties relating to it.

42 *Zen*, supra note 34, at paragraph 18 (FCA).

exceeds

(b) the total of all amounts each of which is an amount paid at or before that time on account of the taxpayer's tax payable and applied as at that time by the Minister against the taxpayer's liability for an amount payable under this Part or Part I.3, VI or VI.1 for the year,

the taxpayer shall pay to the Receiver General interest at the prescribed rate on the excess, computed for the period during which that excess is outstanding.

The subsection provides that a taxpayer who is late in paying his or her "taxes payable . . . shall pay to the Receiver General interest at the prescribed rate." Accordingly, when the provision applies, the minister may oblige a taxpayer to pay, without the benefit of a subsequent assessment, interest that accrues on a tax debt that has been the subject of a notice of assessment.[43]

The wording of subsection 161(1) clearly requires that taxes be payable before an obligation to pay interest arises. However, the 1986 assessment was not for taxes payable. Rather than creating a tax payable, section 227.1 merely increases the number of debtors that the minister may pursue to satisfy an original tax debt. Moreover, the text of subsection 161(1) limits its application to taxes payable under parts I, I.3, VI, and VI.1 of the Act. Even if a director's joint and several liability under section 227.1 was found to be a tax payable, it would not be payable under any of the specified parts of the Act.

In reaching the conclusion that derivative liabilities for tax debts pursuant to section 227.1 were not taxes payable by a director, the court considered jurisprudence that has arisen in the context of derivative assessments issued pursuant to section 160.

Like section 227.1, section 160 makes a third party jointly and severally liable for tax debts owed by the principal tax debtor. Under subsection 160(1), certain recipients of property from a tax debtor may be jointly and severally liable for the transferor's tax debts, including interest accruing on those debts. Pursuant to subsection 160(2), such recipients of property may be assessed "at any time" for amounts owing under subsection 160(1).

Although the interaction of subsections 160(1) and (2) is similar in many respects to the charging and assessing provisions of section 227.1 and subsection 227(10), there are differences between the pairs. Notably, the charging provision in paragraph 160(1)(e) limits the liabilities of the third party to the lesser of (1) the amount by which the fair market value of the property transferred exceeds the amount of consideration given for the property, and (2) the total amounts owing under the Act, including interest, that the transferor was liable to pay in respect of the year of transfer and any previous years.

Notwithstanding these differences, the jurisprudence considering third-party liabilities for interest on an assessment under subsections 160(1) and (2) provides insight into the analogous provisions of section 227.1 and subsection 227(10). In

43 Ibid., at paragraph 19.

particular, the court in *Zen* considered the decision of Dussault J in *Algoa Trust v. The Queen*.[44] Although *Algoa* was distinguishable on the basis that section 227.1 does not limit a third party's liabilities in a manner analogous to paragraph 160(1)(e), the court noted the following observations of Dussault J:

> The rule stated in s. 160 of the Act does not have the effect of creating a tax debt. The effect of the provision is not to create a second debt: there is only one tax debt. . . . There is thus no new debt created under the Act and the obligation arises not from the assessment but from the Act itself. Fundamentally, therefore, there is only one debt and only that debt can bear interest. . . .
>
> Thirdly, I would say that there is no provision of the Act regarding interest that may be applicable to an assessment issued pursuant to s. 160 of the Act. This is logical, since there is no new tax debt and an assessment under s. 160 already incorporates the interest which the transferor owed in addition to the tax. The assessment may also incorporate penalties and interest thereon.[45]

That passage was cited by Cumming J of the Ontario Superior Court of Justice in the class action litigation of *Ho-A-Shoo v. Canada (Attorney General)*.[46] The plaintiffs in the action were seeking restitution for unassessed interest paid on assessments issued pursuant to subsection 160(2). Like the *Algoa* decision, the case was distinguishable from *Zen* on the basis that the unassessed interest was alleged to be in excess of the limits on third-party liability established under paragraph 160(1)(e). However, given Dussault J's conclusions in *Algoa* that (1) there was only one debt in a section 160 tax assessment, and (2) there was no provision for assessing post-assessment interest, Cumming J also raised the question of whether an assessment under subsection 160(2) could ever bear interest.

On the basis of the assertion that section 160 did not create a second tax liability but merely made a third party jointly and severally liable for another's tax debt, Cumming J concluded that an amount owing under a subsection 160(2) assessment was best characterized as a "debt to the Crown" rather than a "tax." Because subsection 161(1) assesses interest on taxes payable, Cumming J concluded that interest could not accrue on an outstanding section 160 assessment.[47]

The court in *Zen* agreed with Dussault J's comments that section 160 does not create a separate tax debt and acknowledged that this argument was equally applicable to directors' liability arising under section 227.1. Because no tax debt is incurred by a director under section 227.1, the court further held that there were no taxes payable by a director for the purposes of subsection 161(1).[48]

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44 1998 CanLII 78 (TCC).

45 Ibid., at paragraphs 3 and 6.

46 2000 CanLII 2238 (Ont. SCJ).

47 Ibid., at paragraph 21.

48 *Zen*, supra note 34, at paragraphs 27 and 39 (FCA).

"Modifications That the Circumstances Require"

Although the court in *Zen* agreed that a tax debt owing pursuant to section 227.1 was not a tax payable as understood in subsection 161(1), the court considered whether the mechanism by which an assessment for taxes owing under section 227.1 is issued under subsection 227(10) might permit the minister to collect unassessed interest arising on a director's derivative liability. Currently, subsection 227(10) reads as follows:

> The Minister may at any time assess any amount payable under
>
> (a) subsection (8), (8.1), (8.2), (8.3) or (8.4) or 224(4) or (4.1) or section 227.1 or 235 by a person, . . .
>
> and, where the Minister sends a notice of assessment to that person or partnership, Divisions I and J of Part I apply with any modifications that the circumstances require.

In addition to allowing the minister to issue a notice of assessment for liability arising under section 227.1, subsection 227(10) incorporates a variety of administrative and procedural provisions from part I of the Act: "Divisions I and J of Part I apply *with any modifications that the circumstances require*" (emphasis added). Because section 161 is found in division I of part I, the court was obliged to consider whether subsection 161(1) might be interpreted to include words such as "or any amount for which a director is liable under subsection 227.1(1)."[49]

The words "with any modifications that the circumstances require" appear to confer broad powers on the courts. However, past court decisions have urged limits on the scope of those powers. The court in *Zen* considered a line of cases identified in *Ketz v. The Queen*,[50] where the Latin phrase "mutatis mutandis," which the current wording of subsection 227(10) replaces, was addressed. Those decisions restricted the scope of the phrase "mutatis mutandis" to necessary changes in points of detail as opposed to changes to the very substance of the provisions in question.

In contrast, the recent decision in *Lord Rothermere Donation v. The Queen*[51] held that the jurisprudence limiting the scope of "mutatis mutandis" to modifications of points of detail was not applicable to the more modern formulation "with any modifications that the circumstances require." Archambault J reached this conclusion by examining subsection 227(7), which experienced a statutory evolution similar to that of subsection 227(10). The original amendment in 1985 changed the phrase "mutatis mutandis" to "such modifications as the circumstances require." It was not until a subsequent amendment in 1997 that "any modifications" was substituted for "such modifications" in the English version of the Act.[52] Archambault J said that

49 Ibid., at paragraph 42.

50 79 DTC 5142; [1979] CTC 186 (FCTD).

51 2009 TCC 70.

52 The French version of the Act remains: "avec les modifications nécessaires."

Parliament would not have used the words "any modifications" if it had intended to preserve the narrow scope of the prior "mutatis mutandis" jurisprudence.[53]

The court in *Zen* commented on the difficulty of discerning whether the "mutatis mutandis" jurisprudence was still applicable to the more modern "with any modifications that the circumstances require" formulation. The court said that the original change from Latin in 1983 was merely intended to make the provision more accessible and was thus in the nature of a consolidation of law. Citing Sullivan,[54] the court noted that there is a strong presumption that consolidations are not intended to make substantive changes to the law. Conversely, it also noted that the 1983 changes were enacted as part of large series of amendments to the Act and that the 1997 changes to the English text were made for reasons other than the elimination of Latin. These last factors may imply that the amendments were intended to have a substantive effect.[55]

Ultimately, the court found it unnecessary to decide whether the "mutatis mutandis" jurisprudence was applicable; it concluded that the modifications to the interpretation of subsection 161(1) necessary to make post-assessment interest payable on an assessment issued under subsection 227(10) in respect of directors' liability under subsection 227.1(1) ("the judicial modifications") were better characterized as changes in points of detail than as changes to the very substance of subsection 161(1). The court offered four principal justifications for its conclusion.[56]

First, the judicial modifications did not increase the amount for which Mr. Zen was liable under section 227.1. The charging provision in section 227.1 clearly states that a director is jointly and severally liable for interest accruing on the original tax debt.

Second, subsection 227(10) authorizes the minister to issue an assessment for amounts owing under section 227.1 "at any time." The court observed, and Mr. Zen conceded, that the minister could have assessed Mr. Zen during the hearing for any interest that accrued after the 1986 assessment and that Mr. Zen would be required to pay the resulting amount. Accordingly, the judicial modifications did not alter the amount that the minister could require Mr. Zen to pay pursuant to subsection 227.1(1).

Third, counsel for the appellant conceded that there was no reason of policy or principle why a director assessed under subsection 227(10) in respect of liability under section 227.1 should not be liable for subsequently accruing interest as if the amount owing were "taxes payable" under subsection 161(1).

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53 *Lord Rothermere Donation*, supra note 51, at paragraph 21.

54 Ruth Sullivan, *Sullivan on the Construction of Statutes*, 5th ed. (Markham, ON: LexisNexis, 2008), at 655-59.

55 *Zen*, supra note 34, at paragraphs 52-54 (FCA).

56 Ibid., at paragraphs 55 and 59-70.

Finally, the judicial modifications allow the minister to commence collection procedures immediately after a director has been advised of the amount of interest that has accrued since the last assessment was issued (rather than giving the director the opportunity to commence a new objection to the updated assessment). Although the court acknowledged that a director would thus be deprived of certain procedural rights of objection and appeal, Mr. Zen was not unduly denied a fair opportunity to challenge the amounts owing. Because Mr. Zen had already discontinued his original appeal against the 1986 assessment with the benefit of legal advice, the court felt it appropriate that he be precluded from disputing the correctness of the 1986 assessment. If he had objections to the calculation of interest, the court observed, he could raise those objections during enforcement proceedings before the Federal Court.

Because the minister generally does not commence collection proceedings during an appeal of an assessment, the accelerated collection process had the virtue of producing a final settlement in a timely manner. The court acknowledged that the loss of a further opportunity to delay proceedings would be detrimental to Mr. Zen. However, it could identify no policy reason to distinguish directors who are jointly liable with a corporation from the corporation itself (or any other taxpayer required to pay interest under section 161 without the benefit of a further notice of assessment). The court concluded that the shortened collection period caused by the judicial modifications was consistent with the scheme of the Act and would enhance its efficient administration. This position was contrasted with Mr. Zen's position, which opened up "the possibility of an unending succession of notices of assessment, notices of objection, and appeals, which are apt to serve little purpose other than to delay the collection of tax. Thus, by the time that one notice of assessment for interest accrued was issued, objected to, and appealed, additional interest would have accrued, and another notice would be required before that interest could be collected."[57]

Statutory Modification Provisions

In determining how broadly a statutory modification provision should be interpreted, courts must consider the delicate balance that exists between certainty and the rule of law on the one hand, and the need to give effect to Parliament's intent on the other. In so doing, courts are required to address matters of policy and weigh the relative merits of efficiency against the benefits of subjecting proposed modifications to the scrutiny of the normal legislative process. Because courts are generally not perceived to be well placed to balance such concerns, they are sometimes subject to accusations of judicial overreaching. The court in *Zen* made the following statements about statutory modification provisions:

57 Ibid., at paragraph 71.

> A statutory modification provision confers an unusual power on courts. The normal role of the judicial branch of government with respect to legislation is to interpret and apply the law as enacted by the Legislature. A cornerstone of parliamentary democracy is that changes to the law require the authorization of the Legislature. However, the exigencies of administration in the modern state have also long required Legislatures to delegate extensive law-making powers. In Canada, these powers are most often delegated to politically accountable bodies and officials with an institutional expertise in public administration, such as the Governor (or Lieutenant Governor) in Council, individual Ministers of the Crown, and municipalities.
>
> The fact that courts have neither of these qualities counsels a cautious approach to the scope of the power delegated to them to modify provisions of the [Act], and indicates that it should be interpreted more narrowly than the current text suggests. Thus, determining whether a proposed modification is permitted by the delegated power (to use the terminology associated with *mutatis mutandis*: is it a change in detail or in substance?) requires a court to consider whether considerations of efficiency outweigh the benefits of subjecting it to the scrutiny of the normal legislative process.
>
> In my opinion, the modifications to subsection 161(1) proposed in the present case do not warrant the costs of requiring a Parliamentary amendment. They do not involve the kinds of technical issues, policy choices or wide ranging implications for the administration of the [Act] which our notions of democratic and responsible government require to be left to be resolved through the legislative process.[58]

In justifying the judicial modifications, the court acknowledged that it was adopting an interpretation that limited Mr. Zen's procedural rights and his ability to delay enforcement of his debt to the Crown. *Ho-A-Shoo*[59] illustrates a more deferential approach that the court might have considered. Like subsection 227(10), subsection 160(2) incorporates the language "with any modifications that the circumstances require." It reads as follows:

> The Minister may at any time assess a taxpayer in respect of any amount payable because of this section and the provisions of this Division apply, with any modifications that the circumstances require, in respect of an assessment made under this section as though it had been made under section 152.

Cumming J concluded in *Ho-A-Shoo* that the statutory modification provision in subsection 160(2) could not apply to make unassessed interest on an assessment issued pursuant to subsection 160(2) payable to the Crown, but he did not elaborate on the rationale for this conclusion. In considering the decision, the court in *Zen* concluded that such a modification would have amounted to a substantive change to the Act because of the limitations on derivative liability in paragraph 160(1)(e).[60]

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58 Ibid., at paragraphs 73-75.

59 *Ho-A-Shoo*, supra note 46.

60 *Zen*, supra note 34, at paragraph 57 (FCA).

After the decision in *Ho-A-Shoo*, the Ministry of Finance proposed amendments to the Act that would clarify that post-assessment interest was payable on assessments issued pursuant to subsection 160(2).[61]

Nonetheless, there are arguably occasions on which statutory modification provisions should be interpreted in a more robust manner than they were in *Ho-A-Shoo*. The court in *Zen* held that the judicial modifications did not raise the types of technical issues, policy choices, or wide-ranging implications that would require resolution through the legislative process.[62] Unlike the proposal in *Ho-A-Shoo* to levy interest beyond the limits on liability in paragraph 160(1)(e), the judicial modifications in *Zen* did not require a substantive change to the Act.

The imposition of limitations on taxpayers' procedural and economic rights should, to the extent possible, be left exclusively to Parliament. However, courts have a duty to give effect to statutory modification provisions passed by the legislature. The decision in *Zen* to read in the judicial modifications should promote the efficient functioning of the tax administration system with only minimal impairment of taxpayers' procedural and economic rights. In the circumstances, the court's decision appears to strike an appropriate balance between the competing demands of efficiency and the protection of taxpayers' rights.

It remains to be seen whether Mr. Zen's 25-year odyssey through the legal system is complete. At the time of writing, he was seeking leave to leave to appeal the decision to the Supreme Court of Canada.[63] Interest continues to accrue.

Andrew Stirling

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61 The draft Income Tax Amendments Act, 2010, released July 16, 2010, would amend subsection 160(2) in respect of assessments issued after December 20, 2002 to read as follows:

> The Minister may at any time assess a taxpayer in respect of any amount payable because of this section, and the provisions of this Division *(including, for greater certainty, the provisions in respect of interest payable)* apply, with any modifications that the circumstances require, in respect of an assessment made under this section as though it had been made under section 152 *in respect of taxes payable under this Part*. [Emphasis added.]

See Canada, Department of Finance, *Legislative Proposals To Amend the Income Tax Act and Related Legislation To Effect Technical Changes and To Provide for Bijural Expression in That Act* (Ottawa: Department of Finance, July 2010).

62 *Zen*, supra note 34, at paragraph 75 (FCA).

63 Docket no. 33851 (SCC).