OSLER

Dow Chemical and Iris Technologies: Supreme Court rules on jurisdictional issues in tax matters

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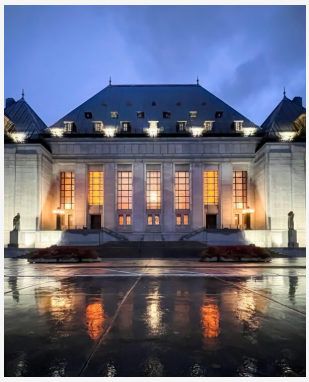

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In this Update:

- On June 28, 2024, the Supreme Court released its decisions in *Dow Chemical* and *Iris Technologies* regarding the respective jurisdictions of the Tax Court and Federal Court in tax matters
- In *Dow Chemical*, the 4-3 majority of the Supreme Court rejected the taxpayer's argument that the Tax Court had jurisdiction to review the Minister's decision to deny a downward transfer pricing adjustment under subsection 247(10) on the basis that it is a discretionary decision, and therefore within the exclusive jurisdiction of the Federal Court
- The companion appeal, *Iris Technologies*, also confirmed the Federal Court's jurisdiction over challenges to discretionary decisions by the Minister; however, the 4-3 majority held that the taxpayer's application for judicial review raised two claims that collaterally challenged the correctness of the assessments and therefore fell within the Tax Court's jurisdiction and, while the third was within the Federal Court's jurisdiction it should be struck for inadequately pleaded facts
- The reasons contain useful guidance on the respective jurisdictions of the Tax Court and the Federal Court and highlights areas for potential legislative reform

On June 28, 2024, the Supreme Court released its decisions in Dow Chemical Canada ULC v. The King, 2024 SCC 23 (Dow Chemical) and Iris Technologies Inc v. A.G. of Canada, 2024 SCC 24 (Iris Technologies). Both cases, heard together on November 9, 2023, address which of the Tax Court of Canada or the Federal Court is the appropriate forum for challenging particular aspects of tax audits and assessments.

The Supreme Court split 4-3 in both appeals, with Kasirer J writing for the majority (joined by Martin, Jamal, and O'Bonsawin JJ), and Côté J (joined by Karakatsanis and Rowe JJ) writing the dissent and concurrence in *Dow Chemical* and *Iris Technologies*, respectively.

These decisions clarify the jurisdictional boundaries of the Tax Court and Federal Court and potentially streamline the process for future disputes, particularly in relation to transfer pricing adjustments and the procedural aspects of tax assessments.

Background to the appeals

At the heart of the jurisdictional debate in these cases was the division of powers between the Tax Court and the Federal Court under the *Tax Court of Canada Act* and the *Federal Courts Act*. Both are statutory courts whose powers are defined by their enabling statutes.

The Tax Court has jurisdiction over various tax matters, notably under the *Income Tax Act* (ITA), the *Excise Tax Act* (ETA) dealing with goods and services tax (GST) and other selected taxes, but its remedial powers are limited. In particular, the Tax Court has the jurisdiction to hear and determine references and appeals regarding income tax, GST, and other selected taxes. This jurisdiction includes appeals from assessments made under these acts.

The Federal Court, on the other hand, is empowered generally to review decisions of federal boards and tribunals, which includes reviewing discretionary decisions made by the Minister of National Revenue in respect of tax matters but has no jurisdiction to hear appeals of tax assessments.

The differing powers of review and available remedies of the two courts complicate the process of determining the appropriate forum for litigating certain aspects of tax disputes. In some cases where there has been uncertainty about which court has jurisdiction, taxpayers have adopted a "belts and suspenders" approach, commencing proceedings in both courts and then requesting that one proceeding be held in abeyance until the other is resolved. It was hoped that the decisions of the Supreme Court in *Dow Chemical* and *Iris Technologies* would clarify this type of uncertainty.

Dow Chemical

Facts and judicial history

The transfer pricing rule in subsection 247(2) of the ITA applies to make both upward and downward adjustments when intercompany transactions are not priced at arm's length. However, subsection 247(10) makes any adjustment that might be favourable to a taxpayer subject to Ministerial discretion. This discretion does not extend to determining whether an adjustment is warranted or the amount of such an adjustment — these aspects are non-discretionary pursuant to subsection 247(2). Instead, the discretion concerns whether "the circumstances are such that it would be appropriate that the adjustment be made."

In *Dow Chemical*, the taxpayer requested a favourable transfer pricing adjustment (referred to as a "downward" adjustment) under subsection 247(10) of the ITA in respect of a transaction with a Swiss affiliate. The Minister reassessed the taxpayer and denied the downward adjustment. The taxpayer pursued parallel proceedings in both the Tax Court and the Federal Court and requested that the proceedings in the Federal Court be held in abeyance.

The Tax Court held that it had jurisdiction over the dispute as part of its power to hear the taxpayer's appeal of the reassessment, but the Federal Court of Appeal overturned that decision and held that the Tax Court does not have jurisdiction to review a discretionary decision made by the Minister. The Supreme Court was tasked with determining whether the Tax Court or the Federal Court was the correct forum for challenging the Minister's discretionary decision under subsection 247(10).

The taxpayer argued that the Supreme Court should broadly interpret the Tax Court's

jurisdiction so that when a taxpayer is appealing an assessment of tax, interest or penalties, the Tax Court is empowered to review all components of the assessment, including those that are based on discretionary decisions made by the Minister. The Minister argued for a narrower interpretation of the Tax Court's jurisdiction on the basis that the determination under subsection 247(10) is discretionary, and therefore falls under the Federal Court's jurisdiction to review decisions of federal boards and tribunals. According to the Minister, "it has been the legislator's long standing intent that the question of liability for tax under the ITA and discretionary decisions be separate and reviewed by different courts."

Supreme Court: majority

In a split 4-3 decision, the majority of the Supreme Court held that the Federal Court has exclusive jurisdiction over discretionary decisions of the Minister under subsection 247(10) — regardless of whether those decisions have resulted in an assessment of tax.

The majority observed that taxpayers are not statutorily entitled to downward adjustments under subsection 247(10). In determining whether to grant such an adjustment, the Minister's role is to perform a "task that is fundamentally different than the non-discretionary act of preparing an assessment," which requires the Minister to apply the law to facts as she understands them.

Although discretionary decisions under subsection 247(10) can be quashed by the Federal Court by way of judicial review, this does not mean that the concurrent assessment of tax liability by the Minister is incorrect, since judicial review focuses on the decision-making process rather than the outcome of a decision. In the majority's view, the Tax Court has jurisdiction only over outcomes, not the conduct of the Minister. In other words, although a decision under subsection 247(10) decision may directly affect and is inextricably linked to an assessment, it should not be characterized as being part of such an assessment.

The majority also pointed out some potential procedural difficulties that would result if it were determined that the Tax Court had the jurisdiction to review a discretionary decision under subsection 247(10). These included the potential prejudice to taxpayer's right to object to an assessment if the Minister's decision *not* to make a downward adjustment is made after the time to object has expired and a new assessment has not been issued.

The majority was also of the view that the Tax Court, unlike the Federal Court, lacks the statutory power to grant an appropriate remedy as it cannot order the Minister to reconsider her discretionary decision under subsection 247(10). In this regard, the majority was apparently not persuaded by the reasoning of the dissent that such a remedy was subsumed in the Tax Court's jurisdiction to refer an assessment back to the Minister for reconsideration.

Supreme Court: dissent

The dissenting judges would have allowed the taxpayer to challenge the Minister's decision in the Tax Court. The dissenting reasons characterized the Minister's power under subsection 247(10) not as permissive but rather as part of the Minister's obligation to determine a taxpayer's liability. Disputes regarding subsection 247(10) decisions are inextricably linked to assessments. They therefore fall within the Tax Court's exclusive jurisdiction over the "validity and correctness of assessments."

In the dissent judges' view, "if the discretion under s. 247(10) is not exercised or not properly exercised, the resulting assessment cannot be correct, because the decision necessarily has an impact on the computation of tax liability."
The dissent also disagreed with the majority's statement that the Tax Court lacked the ability

to grant an appropriate remedy, noting that the Tax Court can refer an assessment back to the Minister for reconsideration and reassessment, and further noting that the Federal Court is without jurisdiction to rule on the correctness of an assessment even if it quashes a decision made under subsection 247(10).

These considerations, along with the fact that the Tax Court is a specialized court, led the dissent to the conclusion that the Tax Court is "better suited to the real substance of the issue to be determined, i.e., the correct amount of tax owing."

Implications

Although the decision in *Dow Chemical* clarifies that a taxpayer seeking to challenge the Minister's refusal to make a downward adjustment must pursue that challenge in the Federal Court, it does not outline how such a challenge is to proceed, nor does it address the complexities of "split jurisdiction" where an assessment under appeal involves upward transfer pricing adjustments as well as a claim for a downward adjustment.

The discretion afforded to the Minister under subsection 247(10) relates to *making* a downward adjustment provided for under subsection 247(2), and not to the basis for or amount of ,such adjustment. In other words, there are two questions at issue whenever the taxpayer requests a downward adjustment: whether the adjustment is correct (i.e., it results from the application of subsection 247(2)) and whether the Minister considers it to be appropriate under the circumstances.

The first question is not (or, prior to *Dow Chemical,* was not considered to be) a discretionary one, and is arguably the threshold issue. Is the Federal Court obliged to make that determination as part of its judicial review? How is the Tax Court to proceed with an appeal of an assessment that reflects both upward transfer pricing adjustments and a decision of the Federal Court following its review of a subsection 247(10) decision? In many circumstances, upward and downward transfer pricing adjustments may be interrelated, and the Tax Court's ability to make a holistic determination of the validity of an assessment may be hindered if it is bound by a Federal Court determination on the latter.

Canada's transfer pricing rules are currently the subject of a comprehensive review as part of a government consultation. The proposed amendments to the rules afford an opportunity to bring about the "thoughtful, comprehensive reform" to the "complex structure" of divided jurisdiction in this area that the majority noted could "only be achieved by Parliament." As also noted in the majority decision, any other approach "could increase uncertainty, cause further litigation over jurisdictional issues, and ultimately undermine access to justice."

Iris Technologies

Facts and judicial history

In *Iris Technologies*, the Federal Court of Appeal found that an application for judicial review made in the Federal Court was a collateral challenge on the validity of assessments under the ETA. Following an audit of its GST/HST returns, the taxpayer faced a second audit and subsequent withholding of refunds by the Minister, prompting the company to seek judicial review on grounds of procedural unfairness.

The taxpayer made three claims for declaratory relief in its judicial review application: (1) that there had been a breach of procedural fairness during the audit, and that the assessments had been issued (2) without a sufficient evidentiary basis and (3) for an improper purpose.

Prior to the application being heard, the Minister reassessed the taxpayer and concluded that no net tax refund was owing.

The Federal Court of Appeal found that the application for judicial review challenged the validity of the assessments themselves and therefore fell within the Tax Court's jurisdiction. The Federal Court of Appeal also pointed out that the requested declarations would not have any real impact on the taxpayer's net tax liability. The assessments would remain in effect unless further reassessments were issued or the Tax Court decided to overturn them.

Supreme Court: majority

The Supreme Court again split 4-3 in Iris Technologies, but with majority and concurring reasons. The Court unanimously agreed that the Federal Court lacked jurisdiction to hear two of the taxpayer's claims for declaratory relief. For the third claim, the majority and concurring judges both agreed it should be struck but split on the basis for doing so.

The majority held that the essential nature of the taxpayer's claims regarding procedural fairness and the lack of evidentiary basis was not to challenge an exercise of discretion by the Minister. Instead, the claims were an attack on the assessment that denied the tax refunds claimed.

The taxpayer's complaint regarding procedural unfairness, namely, that the Minister did not give it time to respond to the proposed adjustments, could be addressed in an appeal to the Tax Court, making such an appeal an "adequate, curative remedy" that could "cure any evidentiary defects in the Minister's assessment." The taxpayer's complaint regarding the lack of evidentiary basis could similarly be addressed by the Tax Court.

The third claim regarding the Minister's improper purpose could be subject to judicial review before the Federal Court. However, the majority concluded it should also be struck because the taxpayer failed to allege any facts regarding the Minister's motive or conduct that would have supported its claim.

Supreme Court: concurrence

The concurring judges agreed that the "essential nature or true character" of all three claims in the taxpayer's application for judicial review amounted to a "collateral attack" on the correctness of the assessments, and the relief sought would have no practical effect. In determining the essential nature or true character of the application, it was held that courts must "look beyond the words used, the facts alleged and the remedy sought," and carry out a holistic and practical reading of the pleadings to determine whether there is a reasonable basis for the applicant's claim.

Implications

Iris Technologies confirms that, in determining whether to allow an application to proceed, courts will focus on the true nature of the taxpayer's claim rather than the language used to articulate it. The concurring reasons written by Côté J also highlight the contrast between the majority's reasoning in the two appeals. Justice Côté pointed out that in *Iris Technologies*, the majority concluded that the Minister's conduct in the audit and assessment process can be remedied by an appeal to the Tax Court but disagreed with this same possibility in *Dow Chemical*.

If you have any questions or require additional analysis on the implications of the Supreme

Court's decisions in *Dow Chemical* and *Iris Technologies*, please contact any member of our National Tax Department.