

THE GENERAL ANTI-AVOIDANCE RULE

“Every man is entitled if he can to order his affairs so as the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however inappropriate the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.”

- Duke of Westminster, [1936] A.C. 1 (U.K. H.L.).

INTRODUCTION

In the modern world, virtually everything that a taxpayer does has tax consequences. Ordering one's affairs so as to reduce the amount of tax that would otherwise be payable as a result of those consequences is tax avoidance. Since 1988, the general anti-avoidance rule (the “GAAR”), housed within section 245 of the *Income Tax Act* (the “Act”),¹ has represented Parliament's attempt to distinguish between acceptable tax planning and inappropriate tax avoidance.

An avalanche of cases, scholarly articles, Canada Revenue Agency (“CRA”) publications, and other materials which discuss the GAAR exist to bury the neophyte. This paper does not review them all; its aim is to summarize the purpose, scope, and impact of the GAAR with a view to providing practitioners with a general understanding of its import.

PRECUSORS TO THE GAAR

Section 245 of the Act was introduced in 1988 as a response to what the Department of Finance perceived was an unacceptable growth in the number of tax avoidance transactions. By then, numerous judicial decisions had sanctioned transactions that were in accordance with the literal text of the Act even if they achieved a result which was clearly contrary to the relevant provision's purpose.

Previous attempts to limit tax avoidance met with limited success. One method was by way of judicially-created anti-avoidance doctrines, the most recognizable of which was the sham doctrine. However, the concept of sham has limited application in Canada, especially following the Supreme Court of Canada's decision in *Stubart Investments Ltd. v. The Queen*, [1984] 1

¹ R.S.C. 1985, c. 1 (5th Supp), as amended. All statutory references herein are to the Act.

S.C.R. 536, where Mr. Justice Estey characterized the “heart and core of a sham” as “deceit,” a high bar for the Crown to succeed.

Parliament also added a series of specific anti-avoidance rules (“SAARs”) to the Act. Some SAARs were targeted at preventing certain specific types of transactions, while others had slightly broader application. The latter type of SAAR was exemplified by former subsection 245(1) of the Act which denied the deduction of any expense incurred in respect of a transaction that “artificially” reduced the taxpayer’s income.

INTRODUCTION AND TEXT OF THE GAAR

By the mid-1980s, the Department of Finance had realized that former subsection 245(1) of the Act was ineffective. It only applied to deductions, and the concept of artificiality was ill-defined and received inconsistent interpretations by the Courts. Parliament found itself unable to keep up with the constantly-evolving and novel methods by which tax planners circumvented the SAARs then found within the Act. Its solution was to add a statutory general anti-avoidance rule to the Act.

On September 13, 1988, the GAAR was born. The text of section 245 has remained almost entirely unchanged since that time, and the salient portions of it currently read as follows:

245. (1) In this section,

“tax benefit” means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty;

“tax consequences” to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount;

“transaction” includes an arrangement or event.

(2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

(3) An avoidance transaction means any transaction

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

- (4) Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction
- (a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of
 - (i) this Act,
 - (ii) the Income Tax Regulations,
 - (iii) the Income Tax Application Rules,
 - (iv) a tax treaty, or
 - (v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or
 - (b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.
- (5) Without restricting the generality of subsection (2), and notwithstanding any other enactment,
- (a) any deduction, exemption or exclusion in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,
 - (b) any such deduction, exemption or exclusion, any income, loss or other amount or part thereof may be allocated to any person,
 - (c) the nature of any payment or other amount may be recharacterized, and
 - (d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,
- in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

In enacting the GAAR, Parliament appreciated that by including terms such as “*bona fide* purposes” and “abuse” the Courts would be tasked with delineating the true scope of the GAAR.

FUNDAMENTAL PRINCIPLES OF THE GAAR

There have thus far been three stages of the GAAR’s lifecycle. The first began with its enactment and was characterized by considerable uncertainty as to how the GAAR would be interpreted by the Courts. The second stage began after the first GAAR case, *McNichol v. R.*, [1997] 2 C.T.C. 2088 (T.C.C.) (“*McNichol*”), was decided, and led to the decision in *OSFC Holdings Ltd. v. R.*, 2001 FCA 260 (“*OSFC*”).

The third stage began on October 19, 2005 with the Supreme Court of Canada’s judgment in *Canada Trustco Mortgage Co. v. The Queen*, [2005] 5 C.T.C. 215 (S.C.C.) (“*Canada Trustco*”).

Canada Trustco was the first case heard by the SCC dealing with the application of the GAAR and it established the approach to be taken in analyzing whether the GAAR applies.

The transactions under review in *Canada Trustco* were factually complex but conceptually straightforward. In essence, the case involved a sale lease-back transaction which allowed the appellant to claim capital cost allowance. The transactions were structured in such a way, however, that the appellant had only minimal economic cost or risk. The Supreme Court of Canada summarized the facts as follows:

Briefly stated, on December 17, 1996, CTMC, with the use of its own money and a loan of approximately \$100 million from the Royal Bank of Canada, purchased trailers from Transamerica Leasing Inc. (“TLI”) at fair market value of \$120 million. CTMC leased the trailers to Maple Assets Investments Limited (“MAIL”) who in turn subleased them to TLI, the original owner. TLI then prepaid all amounts due to MAIL under the sublease. MAIL placed on deposit an amount equal to the loan for purposes of making the lease payments and a bond was pledged as security to guarantee a purchase option payment to CTMC at the end of the lease. These transactions allowed CTMC to substantially minimize its financial risk. They were also accompanied by financial arrangements with various other parties, not relevant to this appeal.²

The Supreme Court justices took the opportunity to provide a considerably lengthy and detailed analysis of the GAAR. As a starting point, they offered the following explanation of the GAAR’s purpose:

The GAAR draws a line between legitimate tax minimization and abusive tax avoidance. The line is far from bright. The GAAR’s purpose is to deny the tax benefits of certain arrangements that comply with a literal interpretation of the provisions of the Act, but amount to an abuse of the provisions of the Act. But precisely what constitutes abusive tax avoidance remains the subject of debate.³

The SCC then set out the following three questions which must be decided in any GAAR analysis:

- 1) Was there a tax benefit?
- 2) Was the transaction giving rise to the tax benefit an avoidance transaction?
- 3) Was the avoidance transaction giving rise to the tax benefit abusive?⁴

² *Canada Trustco* at para. 3.

³ *Canada Trustco* at para. 16.

⁴ *Canada Trustco* at para. 17.

The SCC set out the following basic principles which apply to a GAAR analysis:

- 1) The burden is on the taxpayer to refute: (i) the existence of a tax benefit; and (ii) whether the transaction giving rise to the tax benefit was an avoidance transaction. The burden is on the Minister to establish whether the avoidance transaction was abusive.
- 2) If the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.
- 3) The Court undertaking a GAAR analysis is to proceed by conducting a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the context of the whole Act.
- 4) Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s. 245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance. The central issue is the proper interpretation of the relevant provisions in light of their context and purpose.
- 5) Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.
- 6) Where the Tax Court judge has proceeded on a proper construction of the provisions of the Act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.⁵

⁵ *Canada Trustco* at para. 66.

These principles are foundational to any GAAR analysis and are intended to guide the approach to be taken in assessing whether the three questions outlined by the SCC in *Canada Trustco* are met. Those three questions are each analyzed in turn.

A. TAX BENEFIT

The term “tax benefit” is defined in subsection 245(1) as “a reduction, avoidance or deferral of tax” or “an increase in a refund of tax or other amount” paid under the Act. By necessary implication, those phrases convey the sense that there is some standard against which the reduction, avoidance, deferral, or increase is measured. Indeed, in *McNichol* the Tax Court stated that, “Clearly a reduction or avoidance of tax does require the identification in any given set of circumstances of a norm or standard against which reduction is to be measured.”⁶ That said, in *Canada Trustco* the SCC stated that the existence a tax benefit may in some situations be self-evident, such as when a deduction against taxable income is claimed.⁷

In other circumstances, the existence of a tax benefit may require comparison with an alternative arrangement. If the comparison approach is used, the alternative arrangement must be one that might reasonably have been carried out *but for* the existence of the tax benefit. This principle was analyzed extensively in *Univar Canada Ltd. v. R.*, 2005 TCC 723 (“*Univar*”). In that case, the appellant established a company in Barbados in order to purchase loan receivables from another company in the Univar Group. The Barbadian company earned interest income on those loans and subsequently paid tax-deductible dividends to the Appellant.

In holding that no tax benefit was obtained, Justice Bell held that the impugned transactions had to be compared to an “appropriate alternative arrangement to establish tax otherwise payable.”⁸ The Crown argued that the appropriate alternative arrangement was one where the Appellant purchased the loan receivables itself and earned the interest income directly. Three witnesses familiar with the surrounding facts testified that such a scenario would never have arisen, and thus the Court rejected that alternative as appropriate. Instead, the Court held that the appropriate alternative arrangement was one where the Appellant never acquired shares in the Barbadian

⁶ *McNichol* at para. 20.

⁷ *Canada Trustco* at para. 20.

⁸ *Univar* at para. 42.

company. Compared with that alternative, there was no tax benefit because no additional tax would have been paid had the Appellant not acquired those shares.

Canada Trustco outlined two additional principles applicable to determining the existence of a tax benefit: first, whether a tax benefit exists is a factual, not legal, determination;⁹ and, second, the magnitude of the tax benefit is irrelevant.¹⁰

In practice, the threshold for determining whether a tax benefit exists has been set quite low. In most cases, the existence of a tax benefit is clearly shown as any reduction in tax payable satisfies this test.

B. AVOIDANCE TRANSACTION

The second requirement for the application of the GAAR is that the transaction giving rise to the tax benefit must be an avoidance transaction within the scope of subsection 245(3). The purpose behind this requirement is “to remove from the ambit of the GAAR transactions or series of transactions that may reasonably be considered to have been undertaken or arranged primarily for a non-tax purpose.”¹¹

There are several concepts which underpin the determination of whether a transaction is an avoidance transaction. Those concepts have themselves received significant judicial scrutiny.

1. Transaction

Subsection 245(3) only applies if there is a “transaction.” Black’s Law Dictionary defines the term “transaction” as “1. The act or an instance of conducting business or other dealings; esp. the formation performance, or discharge of a contract.”¹² To this ordinary meaning is added the expanded definition in subsection 245(1) which provides that, “‘transaction’ includes an arrangement or event.”

While the ordinary meaning of “transaction,” plus its expanded definition, are clearly capable of capturing an extremely wide array of acts, there are limits. For example, in *R. v. Canadian*

⁹ *Canada Trustco* at para. 19.

¹⁰ *Ibid.*

¹¹ *Canada Trustco* at para. 21.

¹² *Black’s Law Dictionary*, 9th ed. (St. Paul, MN: West Publishing Company, 2009) at 1635.

Pacific Ltd., [2002] 2 C.T.C. 197 (F.C.A.) the Federal Court of Appeal held that the taxpayer's act of designating certain debentures in Australian dollars was not in and of itself a separate "transaction."

2. Series of Transactions

Paragraph 245(3)(b) stipulates that an avoidance transaction need not give rise to a tax benefit itself provided that it is within a series of transactions that does. Given that almost all tax planning involves multiple transactions, what constitutes a "series" is important to most GAAR analyses.

The historical common law meaning of the expression "series of transactions" was established by the House of Lords as a number of transactions that are "pre-ordained in order to produce a given result" with "no practical likelihood that the pre-planned events would not take place in the order ordained."¹³ This interpretation was adopted by the SCC in *Canada Trustco* at para. 25 and the FCA in *OSFC* at para. 24.

Subsection 248(10) extends the meaning of "series of transactions" to include "related transactions or events completed in contemplation of the series." *OSFC* was the first case to delve extensively into the meaning to be given to subsection 248(10), and held that it "broadens the meaning of series from that defined by the House of Lords."¹⁴

In *OSFC*, the FCA held that subsection 248(10) deems two or more transactions to be a "series" if "the related transaction is completed *in contemplation of* the common law series," which occurs if "the parties to the transaction knew of the common law series, such that it could be said that they took it into account when deciding to complete the transaction."¹⁵ In *Canada Trustco* the SCC adopted the rationale set forth by the Federal Court of Appeal and added that, "the phrase [series of transactions] can be applied to events before or after the basic avoidance transaction found under s. 245(3)."¹⁶ In other words, subsection 248(10) may apply regardless of whether the avoidance transaction occurs before or after the remaining transactions in a series.

¹³ *Craven v. White*, [1989] A.C. 398, at p. 514, *per* Lord Oliver; see also *W. T. Ramsay Ltd. v. Inland Revenue Commissioners*, [1981] 1 All E.R. 865.

¹⁴ *OSFC* at para. 34.

¹⁵ *OSFC* at para. 36 [emphasis added].

¹⁶ *Canada Trustco* at para. 26.

In *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 (the fourth and most recent GAAR case heard by the SCC), a main issue under appeal was the extent to which subsection 248(10) deemed two separate transactions to be part of the same series. The situation in *Copthorne* involved a complex reorganization whereby a parent and subsidiary became “sisters,” or corporations with the same parent company. The companies were then amalgamated with the result that the paid-up capital (“PUC”) of their shares was aggregated in the parent’s hands. If the companies had been amalgamated when they were still parent/subsidiary, the PUC of the subsidiary’s shares would have been cancelled.

No immediate tax benefit arose as a result of this “doubling” of PUC. Indeed, the appellants’ evidence was that at the time the avoidance transaction was undertaken, they did not contemplate using that additional PUC in any specific manner. They certainly did not specifically contemplate the transaction which ultimately occurred. Instead, the appellants intimated that they simply wished to preserve the pre-existing PUC for future benefit.

This benefit was realized two years later when the shares were redeemed for an amount equal to their aggregate PUC. The appellants believed that no deemed dividend arose on the basis that the shares’ PUC was equal to the amount paid. Had a dividend arose, the appellants would have been required to withhold 15% of that dividend against the shareholder’s liability under Part XIII of the Act. The Minister argued that the tax benefit realized on the redemption (that is, no withholding tax) arose as a result of a transaction “related” to the initial doubling of PUC, and thus subsection 248(10) deemed the two transactions to be part of the same series of transactions.

The Supreme Court agreed with the Minister. In re-affirming the comments made in *Canada Trustco*, the SCC held that the term “contemplation” in subsection 248(10) should be read both prospectively as well as retrospectively.¹⁷ A related transaction may be done in contemplation of some future series of transactions, or, conversely, a series of transactions may be done in contemplation of some future related transaction, but regardless of the sequence of events, subsection 248(10) deems the transaction to be part of the same series of transactions.

According to the decision in *Copthorne*, the test which must be satisfied for subsection 248(10) to apply is that “the series was taken into account when the decision was made to undertake the

¹⁷ *Copthorne* at para. 55.

related transaction in the sense that it was done ‘in relation to’ or ‘because of’ the series.”¹⁸ Even though that test does not require a “strong nexus” between a series and the related transaction,¹⁹ it does require “more than a ‘mere possibility’ or a connection with ‘an extreme degree of remoteness.’”²⁰ In *Copthorne*, this test was met because the eventual redemption giving rise to the tax benefit was done because of the prior transaction which doubled the PUC (which the SCC held was an abuse and misuse of subsection 87(3)).

Ultimately, each case will be decided on its own facts and the test outlined by the SCC in *Copthorne* as to whether a series of transactions exists is to be determined on a balance of probabilities.²¹

3. *Bona Fide* Purposes

Once it has been found that a tax benefit arose as a result of a transaction or series of transactions, an avoidance transaction will be found to exist unless the transaction, or every transaction within a series of transactions, was undertaken or arranged “primarily for *bona fide* purposes other than to obtain the tax benefit.”²² As most transactions have both a tax and non-tax purpose to them, this determination ordinarily requires weighing which one was primary.

One item of note is that when a tax benefit arises as a result of a series of transactions, each and every transaction comprising that series must have been undertaken primarily for *bona fide* purposes, otherwise the exception will not be available. This is clear from the wording of and interplay between subsection 245(2) and paragraph 245(3)(b). If a series of transactions gives rise to a tax benefit, any transaction within that series that was not undertaken for primarily *bona fide* purposes other than to obtain the tax benefit will be considered an avoidance transaction.²³ Although the overall purpose of a series of transactions is relevant, it is ultimately the purpose behind each transaction within that series which is determinative.²⁴

¹⁸ *Copthorne* at para. 46.

¹⁹ Distinguishing *MIL (Investments) S.A. v. R.*, 2006 TCC 460 which said at para. 65 that, “There must be a strong nexus between transactions in order for them to be included in a series of transactions.”

²⁰ *Copthorne* at para. 47.

²¹ *Copthorne* at para. 47.

²² Paragraph 245(3)(a) of the Act.

²³ *Lipson*, *infra*.

²⁴ *Mackay v. R.*, 2008 FCA 105 at para. 26.

Determining whether a *bona fide* non-tax purpose was primary requires an objective assessment of the relative importance of the driving forces of the transaction. This is ultimately a factual determination, and given that appellate courts are only to overturn a lower court's findings in cases of palpable or overriding error (provided the trial judge "proceeded on a proper construction of the provisions of the Act and on findings supported by the evidence"²⁵), the conclusions made by the trial court are critical.

Where a legitimate non-tax purpose was the primary reason for a transaction, but there were alternative methods of achieving that objective, the use of a more tax-efficient method does not necessarily make the transaction an avoidance transaction.²⁶ In other words, a transaction undertaken for primarily non-tax reasons does not need to result in a sufficiently large tax liability in order to be viewed as *bona fide*. The Explanatory Notes to the GAAR confirm this:

Subsection 245(3) does not permit the "recharacterization" of a transaction for the purposes of determining whether or not it is an avoidance transaction. In other words, it does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes.²⁷

Adherence to this principle has proven somewhat challenging. This can be seen in reviewing two recent decisions released on the very same day. In the first, *1207192 Ontario Inc. v. The Queen*, 2012 FCA 259 ("*1207192 Ontario*") at paras. 17 and 19, the Federal Court of Appeal said as follows:

The evidence was that Mr. Cross followed the plan he was given, exactly as it was given, because he understood that each and every step in the plan was essential to achieve the desired creditor protection. ... There is no evidence that the creditor protection objective required the issuance of Newco common shares to Numberco. Or, to put it another way, there is no evidence that the creditor protection objective could not have been achieved [another way]..."

Contrast that statement with the following from *Spruce Credit Union v. The Queen*, 2012 TCC 357 ("*Spruce Credit Union*") at para. 69:

Consistent with its decision in *Trustco*, the Supreme Court of Canada in *Copthorne* does not suggest that it is appropriate at the avoidance transaction stage of the analysis to compare the taxpayer's chosen transaction or series to other available structures to see if the taxpayer chose among the

²⁵ *Canada Trustco* at para. 66.

²⁶ See, e.g., *Evans v. R.*, 2005 D.T.C. 1762, where Chief Justice Bowman held that surplus stripping transactions, in connection with which the Appellant used his lifetime capital gains exemption ("LCGE"), were not subject to GAAR. Bowman T.C.C.J. concluded that the primary motivation for the transactions was to enable the Appellant to access funds held corporately, and that simply because there were alternatives open to the Appellant which would not have entitled him to use his LCGE does not mean that there was an avoidance transaction.

²⁷ Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Queen's Printer, 1988); cited in *Canada Trustco* at para. 30.

alternatives primarily based on tax considerations or consequences. This makes sense. If it were otherwise, taxpayers would be obliged to choose a more taxable alternative and the *Duke of Westminster* principle would be completely for naught. It appears to be at least to this extent that the Supreme Court of Canada repeatedly sets out that the *Duke of Westminster* principle co-exists with the GAAR.

Those statements are simply irreconcilable. Whether there is an alternative method by which the non-tax purpose can be achieved, notwithstanding that such alternative would result in greater tax payable, either is or is not relevant. The fact that those two decisions were released on the same day is silent testimony of the difficulty inherent to any GAAR analysis.

C. ABUSE OR MISUSE

Subsection 245(4) makes it clear that transactions are only subject to the GAAR if there is a misuse of any of the provisions of the Act,²⁸ or if there is an abuse having regard to those provisions read as a whole. The terms “misuse” and “abuse” carry the same meaning and thus they are not separate inquiries.²⁹ Determining whether an avoidance transaction constitutes such a misuse or abuse is the final, and often most difficult and controversial, stage in the GAAR analysis.

The Court in *Canada Trustco* was quick to dismiss the notion that artificiality or economic substance, as those terms had been historically used, played any role in determining whether there was a misuse or abuse:

A transaction may be considered to be “artificial” or to “lack substance” *with respect to specific provisions* of the *Income Tax Act*, if allowing a tax benefit would not be consistent with the object, spirit or purpose of those provisions. We should reject any analysis under s. 245(4) that depends entirely on “substance” viewed in isolation from the proper interpretation of specific provisions of the *Income Tax Act* or the relevant factual context of a case. However, abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.³⁰ [emphasis in original]

Instead, the SCC insisted that the “heart of the analysis under s. 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the

²⁸ Or *Income Tax Regulations*, *Income Tax Application Rules*, a tax treaty, or any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under the Act or in determining any amount that is relevant for the purposes of that computation.

²⁹ *Canada Trustco* at para. 43.

³⁰ *Canada Trustco* at para. 60

application of the properly interpreted provisions to the facts of a given case.”³¹ Furthermore, a proper interpretation of the provisions of the Act requires that they “be interpreted in their legislative context, together with other related and relevant provisions, in light of the purposes that are promoted by those provisions and their statutory schemes.”³²

Canada Trustco outlined the following two-step approach to determining whether there has been a misuse or abuse:

- 1) A court must determine the object, spirit or purpose of the provisions of the Act which are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions, and permissible extrinsic aids.
- 2) A court must then examine the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue.³³

The Supreme Court provided that abusive tax avoidance would be found where:

- a taxpayer relies on specific provisions of the Act in order to achieve an outcome that those provisions seek to prevent;
- a transaction defeats the underlying rationale of the provisions that are relied upon; or
- an arrangement circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit, or purpose of those provisions.³⁴

The first step in the above analytical approach is determining the object, spirit, or purpose of the provision(s) of the Act the reliance upon or circumvention of which gave rise to the tax benefit.

³¹ *Canada Trustco* at para. 44.

³² *Canada Trustco* at para. 51.

³³ *Canada Trustco* at para. 55.

³⁴ *Canada Trustco* at para. 45.

1. Identifying the Object, Spirit, or Purpose

The Supreme Court characterized the object, spirit, or purpose of a provision as the “legislative rationale that underlies specific or interrelated provisions of the Act.”³⁵ The Court in *Copthorne* held that a “unified textual, contextual and purposive approach” is to be used in searching for the rationale that underlies the words of the Act.³⁶ Doing so, the SCC said, necessarily requires a Court to perform the “unusual duty of going behind the words of the legislation.”³⁷

That said, the Supreme Court in *Canada Trustco* was explicitly clear that the application of the GAAR depends on specific provisions of the Act. Any analysis of whether an avoidance transaction is abusive must be grounded in the provisions which were allegedly misused or abused. An overriding policy of the Act that is not based on a unified, textual, contextual, and purposive interpretation of specific provisions cannot be used to justify a GAAR assessment. Doing so would, according to the Supreme Court, inappropriately place the formulation of tax policy in the hands of the judiciary and would run counter to the overall policy that tax law be certain, predictable, and fair.³⁸

i. Textual

The starting point for identifying the object, spirit, or purpose of a provision is its text. Although the SCC recognized that “in any GAAR case the text of the provisions at issue will not literally preclude a tax benefit that the taxpayer seeks,” the text may nonetheless shed some light on what the provision was intended to do.³⁹ For example, in *Copthorne* the SCC found that the text of subsection 87(3) suggested that it was concerned with ensuring that not all PUC which was validly created is to be preserved on an amalgamation.

³⁵ *Copthorne* at para. 69, citing Vern Krishna, *The Fundamentals of Income Tax Law* (2009) at 818.

³⁶ *Copthorne* at para. 70.

³⁷ *Copthorne* at para. 66.

³⁸ *Canada Trustco* at paras. 41-42.

³⁹ *Copthorne* at para. 88.

ii. *Contextual*

Even if the text of a provision is clear and unambiguous, the next stage of a GAAR analysis requires an examination of the context within which a provision is located.⁴⁰ This in turn requires an examination of other sections of the Act related to the impugned provision as well as permissible extrinsic aids.⁴¹ However, certain principles of statutory interpretation may not necessarily be relevant to this determination – one example being the “implied exclusion” rule:

[108] Copthorne argues that Parliament has enacted a number of PUC provisions which are intended to prevent taxpayers from inappropriately increasing or preserving PUC. It argues that the detail of the PUC provisions, such as s. 87(3), suggests that where the taxpayer’s actions are not caught by a provision, the actions cannot abuse the purpose of the provision. I interpret this argument as what Professor Sullivan calls “implied exclusion”. In essence the argument is that “there is reason to believe that if the legislature had meant to include a particular thing within its legislation, it would have referred to that thing expressly” (Sullivan, at p. 244). ...

[111] However, the implied exclusion argument is misplaced where it relies exclusively on the text of the PUC provisions without regard to their underlying rationale. If such an approach were accepted, it would be a full response in all GAAR cases, because the actions of a taxpayer will always be permitted by the text of the Act.⁴²

In *Copthorne*, the Court analyzed the following factors in determining the context of subsection 87(3): the concept and scheme of PUC under the Act; the principle of non-consolidation of the financial results of separate corporations for tax purposes; the relevance of the capital gains regime; the partially *in rem* nature of PUC; and the absence of specific “stop-PUC rules” akin to stop-loss rules. These contextual considerations led the Court to conclude that, “payments to shareholders from an amalgamated corporation on a share redemption should not be taxable...only to the extent that such payments reflect investments made with tax-paid funds.”⁴³

iii. *Purposive*

The final step in identifying the object, spirit, or purpose of a provision is undertaking a purposive interpretation of that provision. Tax provisions are intended to “promote purposes related to specific activities,”⁴⁴ and thus this step attempts to ascertain Parliament’s intention behind enacting a particular provision or set of provisions. Similar to the contextual analysis,

⁴⁰ This runs counter to earlier cases which held that a provision with clear and unambiguous wording should not be subject to any judicial limitations or refinements (see, e.g., *Antosko v. Canada*, [1994] 2 S.C.R. 312 and *Friesen v. Canada*, [1995] 3 S.C.R. 103 at para. 53.

⁴¹ *Copthorne* at para. 91.

⁴² *Copthorne* at paras. 108, 111.

⁴³ *Copthorne* at para. 112.

⁴⁴ *Canada Trustco* at para. 52.

uncovering a provision's purpose typically requires an examination of other parts of the Act as well as external sources such as Explanatory Notes. Nevertheless, determining the legislative intent behind a provision can be a divisive issue.

This divisiveness was particularly noticeable in the Supreme Court's third GAAR case, *Lipson v. Canada*, 2009 SCC 1 ("*Lipson*"). In that case, the appellant sought to use the attribution rule in subsection 74.1(1) to his advantage by having certain interest expenses incurred by his wife attributed to him.

The facts in *Lipson* can be summarized as follows:

- On day 1, Mrs. Lipson bought certain shares from Mr. Lipson (the appellant) for \$562,500. Mrs. Lipson financed her purchase through an interest-bearing bank loan. Mr. Lipson did not elect out of the spousal rollover in subsection 73(1) of the Act, so he did not realize a gain on the disposition of the shares.
- On day 2, Mr. Lipson used the \$562,500 received from his wife to purchase a personal-use property.
- On day 3, the house was mortgaged and the mortgage proceeds were used to repay Mrs. Lipson's original loan.

As a result, interest on the mortgage loan, which was paid by Mrs. Lipson, was deductible (by virtue of paragraph 20(1)(c) and subsection 20(3)), but the interest expense was attributed back to Mr. Lipson under subsection 74.1(1) and deducted against his other sources of income. The principal question analyzed by the Supreme Court was not whether the interest was deductible,⁴⁵ but whether the transactions resulted in a misuse or abuse of the provisions of the Act.⁴⁶

In a split decision (4:3), the majority held that the series of transactions giving rise to the tax benefit constituted an abuse or misuse of subsection 74.1(1). In the majority's view:

...the attribution rules in ss. 74.1 to 74.5 are anti-avoidance provisions whose purpose is to prevent spouses (and other related persons) from reducing tax by taking advantage of their non-arm's length status when transferring property between themselves.... Thus, s. 74.1(1) is designed to prevent

⁴⁵ The SCC unanimously and decisively held that the interest remained deductible, in accordance with the principles set forth in *Singleton v. R.*, 2001 SCC 61.

⁴⁶ The parties agreed that there was an avoidance transaction which resulted in a tax benefit.

spouses from benefiting from their non-arm's length relationship by attributing, for tax purposes, any income or loss from property transferred to a spouse back to the transferring spouse.⁴⁷

To the majority, subsection 74.1(1) was enacted to ensure that certain benefits, such as those achieved through improper income splitting, could not be derived through the exploitation of non-arm's length relationships. The majority came to this conclusion without reference to any other jurisprudence, guiding principles, or other extrinsic aids. If they had, they may have realized that inter-spousal transfers may occur at fair market value for *bona fide* economic reasons and still be caught by subsection 74.1(1).⁴⁸

This fact was noted by the dissent in *Lipson*, who claimed that the majority's characterization of the purpose of subsection 74.1(1) offered "too large a field of operation for the GAAR."⁴⁹ To the dissent, none of sections 74.1 – 74.5 imply that Parliament intended that attribution could only be made to a taxpayer's disadvantage; allowing a loss to be attributed from a lower-income spouse to a higher-income spouse does not result in an abuse of subsection 74.1(1), but rather the fulfillment of it.⁵⁰ The dissent accused the majority of resorting to "vague generalities or 'overriding policy'" and unjustifiably injecting an element of uncertainty in tax planning.⁵¹

The split decision in *Lipson* highlights the uncertainty inherent in any GAAR analysis. Undertaking a purposive approach necessarily involves a judge searching for the *raison d'être* for a provision in a variety of places. Weighing those oftentimes competing sources of information inevitably results in a judge superimposing their subjective views on the legislative intent behind a provision. This was the case in *Lipson* and undoubtedly many other decisions.

2. Finding Misuse or Abuse

Once the object, spirit, or purpose of a provision has been identified, the final step is to determine whether the avoidance transaction under review was abusive. The SCC thrice confirmed that a transaction will be abusive where it achieves an outcome the statutory provision sought to prevent, defeats the underlying rationale of the provisions relied upon, or circumvents

⁴⁷ *Lipson* at para. 32.

⁴⁸ Subsection 74.5(1) may provide relief in such situations, but only if each of paragraphs 74.5(1)(a), (b) and (c) are satisfied.

⁴⁹ *Lipson* at para. 76.

⁵⁰ *Lipson* at paras. 76 and 81.

⁵¹ *Lipson* at para. 67.

the application of certain provisions in a manner that frustrates the object, spirit, or purpose of those provisions.⁵²

The SCC was explicitly clear that the GAAR is not to be interpreted to introduce an element of uncertainty in tax planning. As such, only in cases where the abusive nature of the transaction is clear should GAAR apply.⁵³ Although the lack of economic substance in an avoidance transaction should not automatically make that transaction abusive,⁵⁴ it is clear that Courts take a dimmer view of such transactions.

This was apparent in *Kaulius v. Canada*, 2005 SCC 55 (“*Kaulius*”) which was released by the SCC concurrent with its decision in *Canada Trustco*. In *Kaulius*, the transactions were factually complex but essentially allowed a pregnant loss to be transferred from an insolvent trust company (STC) to a non-arm’s length partnership, which subsequently realized the loss and allocated it to its partners. Those partners were dealing at arm’s length with STC and would not have been able to utilize the loss absent the transfer to the intervening partnership.

In issuing its decision, the SCC declined to provide much by way of general comment, having already done so in *Canada Trustco*. However, the Court did provide the first example of how the Courts should approach a GAAR analysis in the post-*Canada Trustco* era.

The provision under review in *Kaulius* was subsection 18(13). As described by the SCC, “the purpose of s. 18(13) in particular is to prevent a taxpayer who is in the business of lending money from claiming a loss upon the superficial disposition of a mortgage or similar non-capital property).”⁵⁵ By transferring losses to a non-arm’s length partnership, instead of directly to the Appellants, the pregnant loss of STC could be utilized by the Appellants in an indirect manner. This, the SCC held, constituted abusive tax avoidance.

In coming to its decision, the SCC held that the following factors were relevant:

- The losses originated from the failure of a party (STC) dealing at arm’s length with the appellants.

⁵² *Canada Trustco* at para. 45; *Lipson* at para. 40; *Copthorne* at para. 72.

⁵³ *Canada Trustco* at para. 50.

⁵⁴ *Canada Trustco* at paras. 57.

⁵⁵ *Kaulius* at para. 53.

- The intervening partnership was merely a “holding tank” for the unrealized losses.
- STC planned from the outset to sell its interest in the partnership after 18(13) applied.
- The non-arm’s length relationship between STC and the intervening partnership was vacuous and artificial.

Although the SCC attempted to ground its analytical approach in a contextual and purposive interpretation of subsection 18(13) (and related provisions such as section 96), the factors cited by the Court readily suggest that it placed considerable emphasis on the economic insubstantiality of the transactions. The reference to the “vacuity” and “artificiality” of the non-arm’s length aspect of the relationship between STC and the intervening partnership does not comport easily with several comments made in *Canada Trustco*.⁵⁶

It is also unclear why the Court took a broader and more purposive interpretation of the loss provisions in *Kaulius* than it did of the CCA provisions in *Canada Trustco*. The primary goal of both series of transactions was to generate a tax attribute (be it the deduction of losses in *Kaulius* or the deduction of CCA in *Canada Trustco*). As such, the holdings in *Kaulius* and *Canada Trustco* are somewhat difficult to reconcile.

In any event, once it has been found that a tax benefit resulted from an abusive avoidance transaction, the GAAR applies. The final question is what consequences arise therefrom.

CONSEQUENCES TO THE APPLICATION OF THE GAAR

If the GAAR applies, subsection 245(2) provides that the “tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny [the] tax benefit.”

In virtually all circumstances, the result of the GAAR applying is that the taxpayer is treated as having not realized the tax benefit. In *Kaulius*, the appellants were prevented from deducting the losses they originally claimed. In *Lipson*, the deduction claimed by Mr. Lipson was denied (though Mrs. Lipson was allowed to claim that deduction instead). In *Copthorne*, the appellant was required to pay the withholding tax it sought to avoid.

⁵⁶ See, e.g., *Canada Trustco* at paras. 57 and 60.

The denial of the tax benefit is the extent of the consequences to the application of the GAAR. Unlike certain other jurisdictions, no penalties are imposed if the GAAR applies.⁵⁷ As such, there is no downside risk (apart from interest) to undertaking a transaction which may be subject to the GAAR, which in some ways runs counter to its purpose (which is to discourage taxpayers from carrying out abusive tax avoidance). Even penalties imposed by the Minister because of non-compliance with a technical section of the Act are unwarranted.⁵⁸

RECENT DEVELOPMENTS IN THE GAAR

Since *Canada Trustco*, there have been approximately 30 cases before the Courts in which the GAAR was argued (not including RRSP Strips, Barbados spousal trusts, and provincial GAAR cases). Of those, GAAR applied in approximately 10 cases, did not apply in another 13, and was moot point in a further seven (because one of the Crown's technical arguments succeeded⁵⁹).

Despite the numerous guiding principles elucidated in *Canada Trustco*, subsequent judicial decisions have shown that the path set forth by the SCC is not easily followed. Attempting to reconcile all of the GAAR analyses undertaken by the Courts in the post-*Canada Trustco* era is nearly impossible (as the above excerpts from *1207192 Ontario* and *Spruce Credit Union* demonstrate). That said, two recent developments warrant special mention.

A. VALUE SHIFT CASES

In three recent decisions of the Federal Court of Appeal (*1207192 Ontario*; *Triad Gestco Ltd. v. The Queen*, 2012 FCA 258 (“*Triad Gestco*”); and *The Queen v. Global Equity Fund Ltd.*, 2012 FCA 272 (“*Global Equity*”)), the FCA considered the application of the GAAR in relation to “value shifting” strategies which triggered the realization of “paper losses” (which the respective taxpayers sought to deduct for tax purposes). These decisions have stirred up a considerable amount of controversy and raise questions about the future direction of the GAAR.

In each of those cases, the taxpayer had initially subscribed for common shares of a corporation for a substantial amount. The corporation then issued a stock dividend to the taxpayer comprised

⁵⁷ Penalties are imposed under similar tax legislation in the United States, Australia, New Zealand, and other countries.

⁵⁸ *Copthorne Holdings Ltd. v. R.*, 2007 TCC 481 at para. 77. For a full explanation of why penalties are not warranted when the GAAR applies, see paras. 77 and 78 of that decision.

⁵⁹ See, e.g., *Brent Kern Family Trust v. R.*, 2013 TCC 327.

of a separate class of preferred shares having a large redemption value but nominal paid-up capital.⁶⁰ The effect of the stock dividend was to shift value from the common shares (which were then sold by the taxpayer to an unaffiliated person) to the preferred shares (which were retained by the taxpayer). The CRA sought to apply the GAAR to disallow the loss realized by the taxpayer on the disposition of the common shares.

In each case, the Federal Court of Appeal ruled that the GAAR applied to disallow the loss claimed by the taxpayer since the taxpayer had suffered no true economic loss. Although the Court recognized that to restrict the deduction of losses to “only the deduction of business losses that reflect an ‘actual reduction in wealth’ or ‘an actual economic loss’” would be inappropriate, they also said that “if a business loss is to be used for taxation purposes...there must, at the very least, be an air of economic or business reality associated with that loss.”⁶¹ By carrying out transactions that resulted in a mere “paper loss,”⁶² the transactions giving rise to the loss resulted in an abuse and misuse of the relevant provisions of the Act relating to the deductibility of losses.

In effect, the FCA held that the cost to the appellant of its common shares should be determined by reference to the amount economically at risk. In that regard, the following comments from *Canada Trustco* appear relevant:

The appellant [the Crown] suggests that the usual result of the CCA provisions of the Act should be overridden in the absence of real financial risk or “economic cost” in the transaction.... The applicable CCA provisions of the Act do not refer to economic risk. They only refer to “cost”. Where Parliament wanted to introduce economic risk into the meaning of cost related to CCA provisions, it did so expressly, as, for instance, in s. 13(7.1) and (7.2) of the Act, which makes adjustments to the cost of depreciable property when a taxpayer receives government assistance.... Like the Tax Court judge, we see nothing in the GAAR or the object of the CCA provisions that permits us to rewrite them to interpret “cost” to mean “amount economically at risk” in the applicable provisions.

That said, in *Kaulius* the Supreme Court did say that the vacuity and artificiality of transactions are relevant to determining whether they are abusive. The transactions done in the three value shift cases were clearly aggressive, but whether they were truly abusive (and whether the FCA’s comments were appropriate) remains a subject of debate.

⁶⁰ Since the paid-up capital of the preferred shares issued as a stock dividend was nominal, the amount of the dividend deemed to be paid to the taxpayer was also nominal.

⁶¹ *Global Equity* at paras. 60 and 63.

⁶² *Global Equity* at para. 66.

B. THE JUDICIAL “SMELL” TEST

Judicial uncertainty with respect to the GAAR is inevitable. By drafting section 245 so broadly, Parliament placed the responsibility of deciding which transactions constitute acceptable tax planning and which constitute abusive tax avoidance on the Courts. This line-drawing exercise has been problematic and the *Triad Gestco*, *1207192 Ontario*, and *Global Equity* cases highlight a broader trend emerging in the GAAR jurisprudence: the presence of a so-called “smell test.”

The purpose of the GAAR is to deny any tax benefit realized as a result of a transaction or series of transactions which violates the object, spirit, or purpose of a provision of the Act. That said, in *Copthorne* it was specifically stated that morality or conceptions about “right vs. wrong” are irrelevant:

The terms “abuse” or “misuse” might be viewed as implying moral opprobrium regarding the actions of a taxpayer to minimize tax liability utilizing the provisions of the Income Tax Act in a creative way. That would be inappropriate. Taxpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability (see *Duke of Westminster*)....

...determining the rationale of the relevant provisions of the Act should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do.⁶³

However, in cases where the transactions under review appear especially offensive (such as in *Triad Gestco*, *1207192 Ontario*, and *Global Equity*), the Courts have shown a much stronger tendency to find such transactions abusive. As the Honourable Justice Bowman described it:

The first thing that is absolutely certain, in my view, is that whether you win or lose a GAAR case depends on the judge you get in the first instance. As Al [Meghji] said, another judge might have decided *Lipson* differently from the way I decided it. *MIL* might have gone differently, perhaps, if I had heard it. So Al has been very complimentary to the Tax Court in saying that it has formulated a judicial test. On the same basis, though, I think that there continues to be a certain visceral element—people inelegantly call it the smell test, the olfactory factor, the gut reaction. Al put it very well when he said, “Does this offend a judge's fiscal morality?” And if something does, then I think you are going to lose.⁶⁴ [emphasis added]

Although Justice Bowman may have been overstating the matter, the degree to which a transaction “feels” abusive has become increasingly influential. Of course, it is impossible to conclusively point to any decision as having been decided on such a basis.

⁶³ *Copthorne* at paras. 65 and 70.

⁶⁴ Hon. Donald G.H. Bowman et al., “GAAR: Its Evolution and Application,” Report of the Proceedings of the Sixty-First Tax Conference, 2009 Tax Conference (Toronto: Canadian Tax Foundation, 2010), 2:1-22.

One recent example of where the smell test likely played a role is *Pièces Automobiles Lecavalier Inc. v. The Queen*, 2013 CCI 310 (Fr.) (TCC) (“*Lecavalier*”). In that case, Ford U.S. was planning to sell one of its Canadian subsidiaries (Greenleaf) to a Canadian purchaser for a purchase price of approximately \$10M. That price was less than the then-outstanding debt owing by Greenleaf to Ford U.S. of \$25M. Prior to completing the sale, Ford U.S. subscribed for approximately \$15M of common shares of Greenleaf, and the same day Greenleaf used those funds to repay a portion of the debt it owed to Ford U.S. Had these “cash circling” transactions not been undertaken, the debt parking rules in section 80.01 would have applied on the sale of Greenleaf’s shares.

In holding that GAAR applied, Bédard J. of the Tax Court stated that the capital injection was “temporary,” the appellant managed to “artificially” reduce its debt to avoid the debt parking rules, the appellant “clearly circumvented” the application of sections 80 and 80.01, and that the transactions were “clearly abusive avoidance transactions.”⁶⁵

This is but one example of a larger trend, and there are cases decided in the taxpayer’s favour which may also have involved the judicial smell test.⁶⁶ Only time will tell if the comments made by Justice Bowman become obsolete and a more principled approach becomes paramount.

CONCLUSION

The GAAR is a relatively recent phenomenon in Canadian jurisprudence. Its introduction was a watershed moment in Canadian income tax history. Through its four GAAR cases, the Supreme Court has attempted to provide some guidance as to the principles which underlie the GAAR, the methodology to be used in analyzing whether it applies, and the circumstances in which a transaction will be found abusive.

Despite this guidance, it is difficult to accurately predict how a court might apply the GAAR to a given set of circumstances. The differing majority and minority decisions of the Supreme Court of Canada in *Lipson* clearly illustrate that the application of the GAAR principles (as established in *Canada Trustco*) involve significant subjective interpretation. The extent to which the *Duke* can survive in light of the GAAR remains to be seen.

⁶⁵ *Lecavalier* at paras. 122-124.

⁶⁶ See, e.g., *Swirsky v. R.*, 2013 TCC 73 and *Gwartz v. R.*, 2013 TCC 86.