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Challenges in Shifting Canadian Taxation Toward Consumption

Jonathan Rhys Kesselman and Peter S. Spiro*

PRÉCIS
Les analystes de la politique fiscale canadienne sont très en faveur de privilégier la taxe sur les produits et services/taxe de vente harmonisée — une taxe à la consommation — plutôt que l’impôt sur le revenu des particuliers comme source de revenus, ou encore d’augmenter la proportion de la taxe à la consommation dans l’assiette de l’impôt des particuliers. Cette étude va à l’encontre des recommandations en matière de politique fiscale du « consensus d’experts » et évalue de façon critique les preuves théoriques et empiriques relatives au comportement dans les domaines de l’effort de travail, de l’épargne, de l’investissement, de la croissance économique, de l’efficacité et de l’observation fiscale. L’étude examine plus à fond l’échec de l’opinion consensuelle à expliquer de manière adéquate les effets régressifs des modifications prescrites à la politique fiscale.

La plupart des analyses des experts faisant consensus s’appuient largement sur des preuves étrangères tout en ignorant le fait que l’impôt direct des particuliers au Canada est déjà fortement orienté vers une assiette de taxation de la consommation. Les revenus du capital qui demeurent assujettis à l’impôt des particuliers se concentrent dans les groupes aux revenus les plus élevés, ce qui est bien loin d’un traitement fiscal axé sur la consommation. D’ailleurs, l’opinion consensuelle des experts néglige souvent l’ouverture de l’économie canadienne et le recours massif des sociétés au financement interne — deux facteurs qui amoindrissent l’incidence des encouragements à l’épargne personnelle sur l’investissement des entreprises canadiennes. L’examen minutieux des deux études empiriques canadiennes les plus citées par ces analystes indique un détournement des inférences relatives à la politique fiscale pour parvenir à leur conclusion.

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Nous concluons que les réformes proposées sont défectueuses quant à leurs affirmations de gains économiques importants au moyen d’incitatifs, d’efficacité et de croissance. La plupart des gains économiques invoqués sont exagérés, discutables ou inexistants. Un examen attentif des preuves théoriques et empiriques indique que les principales hypothèses sont faibles ou vulnérables. La plupart des gains économiques putatifs qui découleraient d’une transition vers un régime fiscal davantage axé sur la consommation diminuent ou disparaissent quand la réforme est contrainte de n’avoir aucune incidence sur la répartition. Ainsi, c’est la transition vers un régime fiscal plus régressif implicite dans de telles réformes plutôt que vers une assiette de taxation de la consommation en soi qui génère de tels gains potentiels. Les deux types de réformes nuiraient à la répartition du fardeau fiscal à moins qu’elles soient accompagnées d’une augmentation du barème des taux d’impôt des particuliers. Cette étude examine les conditions requises pour faire en sorte que les réformes proposées n’aient aucune incidence sur la répartition ainsi que sur le revenu.

**ABSTRACT**

Tax policy analysts in Canada have widely promoted shifting revenues away from the personal income tax and toward the consumption-based goods and services tax/harmonized sales tax, or shifting the personal tax base further toward consumption. This study challenges the “consensus expert” policy recommendations by critically assessing the theoretical and empirical evidence relating to behaviour in the areas of work effort, saving, investment, economic growth, efficiency, and tax compliance. The study further examines the failure of the consensus view to account adequately for the regressive impacts of the prescribed policy changes.

Most of the consensus expert analyses rely heavily on foreign evidence while ignoring the fact that the Canadian direct personal tax is already highly oriented toward a consumption base. Capital incomes that remain subject to the personal tax are concentrated in the highest income groups, and these constitute the largest departure from consumption-tax treatment. Moreover, the consensus expert view often neglects the openness of the Canadian economy and heavy corporate reliance on internal finance—both factors that mute the impact on domestic business investment of any stimulus to personal savings. Scrutiny of the two Canadian empirical studies most cited by these analysts reveals an overstretch from the policy inferences that can properly be drawn.

We conclude that the proposed reforms are deficient in their claims of large economic gains via incentives, efficiency, and growth. Most of the asserted economic gains are overstated, controvertible, or non-existent. Careful review of the theoretical and empirical evidence reveals a lack of robustness or vulnerability to key assumptions. Most of the putative economic gains from shifting the tax system further toward consumption diminish or vanish when the reform is constrained to be distribution-neutral. Thus, it is the move toward a more regressive tax system implicit in such reforms rather than moves toward a consumption base per se that generates any such potential gains. Both types of reform would adversely affect the distribution of the tax burden unless accompanied by a steepening of the personal tax rate schedule. This study examines the requisite conditions for making the proposed reforms distribution-neutral as well as revenue-neutral.

**KEYWORDS:** TAX MIX■ CONSUMPTION TAXES■ INCOME TAXES■ TAX REFORM■ SAVINGS■ INCENTIVES
Most economists argue that consumption taxes are generally more advantageous than income taxes. 


INTRODUCTION

Among Canadian tax policy experts in academic, think tank, and business arenas, a near-consensus supports a shift in the revenue mix away from personal income tax and toward greater reliance on indirect consumption taxes like the goods and services tax (GST) and the harmonized sales tax (HST). For example, the experts expressed near-unanimous opposition to the GST rate cuts in 2006 and 2008, with the typical comment being that a cut in personal income taxes (PIT) would have been far preferable. Similarly, expert opinion has widely supported reforms to the PIT—such as expanded access to registered retirement savings plans (RRSPs), registered pension plans (RPPs), and tax-free savings accounts (TFSAs)—that would make its base more consumption-oriented. This “consensus expert view” has relied on diverse arguments and evidence to support the benefits of the proposed tax reforms in terms of enhanced...
incentives, efficiency, and economic growth. However, these analyses have often failed to examine the evidence from a sufficiently critical stance or, in citing international evidence, to consider how Canadian tax provisions differ. Moreover, these analyses have typically neglected or downplayed the adverse distributional impacts that could result from such reforms.

In this study, we begin by reviewing the claims of Canadian tax experts with respect to the mooted tax reforms and find that almost all have focused on efficiency issues to the neglect of vertical equity. We discuss how the personal income tax in Canada already embodies a tax base much closer to consumption than income for the great majority of taxpayers other than those at the highest income and wealth levels. We then critically assess the evidence on key economic claims made by the advocates of reform and find that most of those claims are either overstated, controvertible, or without solid foundation. Finally, we evaluate concrete proposals that would make the Canadian tax system more consumption-oriented—either by shifts from personal tax toward indirect taxes or by changes to the base of the personal tax system. In that exercise, we examine the requirements for policy reforms that would maintain distributional neutrality as well as revenue neutrality.

CONVENTIONAL EXPERT WISDOM

Shifting the Tax Mix

The federal government’s two cuts to the GST rate in 2006 and 2008 have been criticized by a near-unanimity of Canadian economists in both academe and think tanks. CBC News issued a report with the heading “Economists Dump on Harper’s GST-Lowering Plan” and quoted academic economist Jim Davies’s description of the move as “stupid, stupid, stupid, stupid”—a refrain echoed by other analysts and media commentators. The report also quoted this comment by Bill Robson of the C.D. Howe Institute:

From an economic point of view, it wouldn’t be my first choice. If you want tax cuts that are going to promote work, going to promote saving, help us invest more and raise living standards in the future, the GST is not the tax you would go after.

The Globe and Mail later reported that

[all 20 [surveyed] economists said other tax cuts would be better for the country than trimming another percentage point from the goods and services tax. . . . It’s a remarkable show of unanimity on public policy.}

2 Ibid.
3 Tavia Grant, “Tories Rebuked on GST: A Poll of Top Economists Finds Unanimous Opposition to the Government’s Plan To Reduce the Goods and Services Tax,” Globe and Mail, October 25,
Economist Don Drummond, then with Toronto-Dominion Bank, stated:

The GST rate cuts don’t move that agenda [to make Canada’s workers and companies competitive] forward at all.4

Shifting the tax mix toward greater reliance on the GST/HST and reduced use of other taxes—particularly the PIT and corporate income tax—has been a perennial theme of Canadian policy analysts since long before the GST rate cuts and continuing to this day.5 Two economists writing for the C.D. Howe Institute in 1999, Jean-Yves Duclos and Julie Gingras, argued for cutting PIT rates while maintaining indirect consumption tax rates, a reform that would unavoidably reduce overall tax progressivity.6 They asserted:

Because income taxes are assessed on the returns from savings as well as on wages, the Canadian economy also experiences less capital investment and lower productivity and income growth than it could.7

Similar arguments appear in most of the later studies advocating a tax-mix shift. Jack Mintz endorsed “a sharp increase in sales tax revenues (sales and excise) to reduce income taxes” combined with “a major expansion of RRSP and pension limits to allow for greater accumulation of wealth.”8 “The advocacy of a tax-mix shift based on the presumed greater economic efficiency of consumption taxes has been echoed in studies published by think tanks such as the Institute for Competitiveness & Prosperity,9


4 Grant, supra note 3.

5 As we note below, the economic evidence does support a shift away from corporate income taxes and toward the GST/HST in terms of efficiency and growth, but our focus in this study is on proposals to shift away from PIT.

6 Jean-Yves Duclos and Julie Gingras, Mixing It Up: Directions for Federal Tax Reform, C.D. Howe Institute Commentary no. 126 (Toronto: C.D. Howe Institute, June 1999).

7 Ibid., at 2.


the Fraser Institute,¹⁰ and the Conference Board of Canada,¹¹ as well as by academ-
ics writing for the University of Calgary’s School of Public Policy.¹² The latest call
for a shift in the federal tax mix toward the GST appears in a study published in
March 2013 by the C.D. Howe Institute.¹³

Shifting the tax mix toward indirect consumption tax has also been advocated for
the Canadian provinces, with a particular focus on the introduction of a provincial
sales tax in Alberta.¹⁴ Kenneth McKenzie examined the replacement of Alberta’s
single-rate income tax with a new provincial sales tax.¹⁵ While estimating significant
economic gains, he reported that even with a non-progressive PIT (other than the
basic exemption), the change would be regressive. Bev Dahlby’s analysis supported
a shift of revenue from provincial corporate income taxes toward either the PIT or
sales tax, with emphasis on the introduction of an Alberta sales tax.¹⁶ His analysis
indicated substantial economic gains from shifting taxes toward consumption
(which either the tax mix or direct tax reform) and noted the reduced progressiv-
ity that would result. Economic debate over whether Alberta should introduce a
sales tax to reduce its provincial PIT continues to the present time, with advocates
such as Dahlby,¹⁷ Mintz,¹⁸ Philip Bazel and Mintz,¹⁹ and Colin Busby and Alexandre
Laurin,²⁰ and critics such as Kesselman.²¹

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¹⁰ Bev Dahlby, “Restructuring the Canadian Tax System by Changing the Mix of Direct and
Indirect Taxes,” in Tax Reform in Canada, supra note 8, 77-108; and Jason Clemens, Niels
Veldhuis, and Milagros Palacios, Tax Efficiency: Not All Taxes Are Created Equal, Studies in
Economic Prosperity no. 4 (Vancouver: Fraser Institute, January 2007).
¹¹ Glen Hodgson, “Reinventing the Canadian Tax System: The Case for Comprehensive Tax
Reform,” Executive Action [Conference Board of Canada], March 2012, 1-10.
Research Papers [University of Calgary School of Public Policy] 1-22; and Bev Dahlby,
¹³ Alexandre Laurin and William B.P. Robson, Prudence and Opportunity: A Shadow Federal Budget for
2013, C.D. Howe Institute Commentary no. 375 (Toronto: C.D. Howe Institute, March 2013).
¹⁴ Several US states have also been shifting their revenue mix further toward sales taxes, some
even aiming to abolish their PIT, on the basis of economic arguments similar to those assessed
in this article: Richard W. Stevenson, “Governors Push Bigger Reliance on Sales Taxes,” New
¹⁵ Kenneth J. McKenzie, Replacing the Alberta Personal Income Tax with a Sales Tax: Not Heresy but
Good Economic Sense (Calgary: Canada West Foundation, October 2000).
¹⁶ Dahlby, supra note 10.
¹⁷ Dahlby, supra note 12.
¹⁹ Philip Bazel and Jack M. Mintz, “Enhancing the Alberta Tax Advantage with a Harmonized
²⁰ Colin Busby and Alexandre Laurin, The 8 Percent Solution: A Sensible Tax Compromise for Albertans,
C.D. Howe Institute E-brief 159 (Toronto: C.D. Howe Institute, July 2013). The top 1 percent
(Footnotes 20 and 21 are continued on the next page.)
Reforming the PIT Base

Shifting the base of the PIT further toward consumption has been a similarly popular theme for tax policy analysts in Canada. These proposals almost invariably have not been couched as revenue-neutral reforms, and they typically have ignored or dismissed the distributional impacts. One example is Herbert Grubel’s proposal to cut the tax on capital gains to zero; Grubel dismisses the notion that this would reduce vertical equity, arguing that the apparent high concentration of capital gains among the top income groups is “quite misleading because the income used to classify families includes capital gains and these gains often are a rare event.” Another example is recurrent proposals to raise RRSP and RPP contribution limits based on the argument that the highest earners should be able to save for retirement with the same consumption tax treatment as others. These proposals rarely suggest that the upper-bracket tax rates should also be increased, thus implying reduced effective tax progressivity. The adverse distributional impact of raising the TFSA contribution and 2 percent of earners would be the biggest winners from the proposal by Busby and Laurin, but this result is not evident in the study because it presents distributional impacts only by income quintiles. In contrast, the proposal by Bazel and Mintz, supra note 19, avoids adverse distributional impacts by cutting the tax rate on lower to middle income brackets (from Alberta’s current 10 percent rate to zero) by much more than the cut for the highest income earners (by just 1 percentage point); this illustrates well an analytical point that we make later in our article.

22 In addressing the adverse distributional impacts of shifting taxation toward consumption, Dahlby, supra note 10, at 102, remarked, “Redistributive policy objectives should be pursued through government expenditures rather than taxes because redistributive expenditures are more cost effective than highly progressive taxes.” Cnossen, supra note 12, at 18, approvingly cites Dahlby on this point while claiming elsewhere that his analysis assumes distributional neutrality.
23 Herbert G. Grubel, “Why There Should Be No Capital Gains Tax,” in Tax Reform in Canada, supra note 8, 139-62, at 149. Curiously, Grubel seeks to support his contention by citing figures on the amounts of capital gains income reported by families with less than $50,000 of non-capital-gains income in a single year (1992). A more telling measure would be the concentration of capital gains income within total incomes over an extended period.
limits is dismissed in a recent article by Finn Poschmann with the apt title “Why We Should Not Fear Expansion of Tax-Free Savings Accounts.”


26 Ibid., at 396.


contribution limits have been articulated by Armine Yalnizyan and Kesselman. Robin Roadway has advocated moving the PIT fully to a consumption base, but in a reform package that includes a more highly progressive rate structure and a lifetime tax on inheritances.

In contrast to the relative neglect of vertical equity among Canadian tax policy analysts seeking a more consumption-based system, this issue has received much closer scrutiny among analysts elsewhere. In the United States, economists have investigated the distributional aspects of shifting the PIT fully to a consumption base. They have also critiqued on distributional grounds American proposals to replace the federal PIT with a flat-rate consumption-based tax, a USA (unlimited savings allowance) personal tax, or a national retail sales tax. In Australia, economists have assessed analytically and quantitatively the distributional impacts of shifting the tax mix between direct and indirect taxes, and an extensive monograph has been published on the topic. Analysts have also estimated the regressivity of indirect taxes

31 Robin Roadway, “Rethinking Tax-Transfer Policy for 21st Century Canada,” in Fred Gorbet and Andrew Sharpe, eds., New Directions for Intelligent Government in Canada: Papers in Honour of Ian Stewart (Ottawa: Centre for the Study of Living Standards, 2011), 163-203. We later posit serious doubts as to whether it is realistic, in practical and political terms, for Canada to consider adopting the effective taxes on wealth transfers needed for such a scheme to be distributionally neutral.
for five European countries and found that the adverse distributional impacts of a
direct-indirect tax-mix shift could be offset by raising PIT rate progressivity.36

Distributional Issues
A few of the consumption tax proponents have acknowledged, in passing, the adverse
distributional impacts of the proposed tax reforms. However, they have addressed
the issue in ways that do not fully remediate the adverse impacts. One commonly
noted proposal to address the regressive impact of shifting the tax mix away from the
PIT and toward the GST/HST is to enrich the refundable tax credits for lower-income
households.37 For example, Dahlby specifies “measures, such as refundable tax cred-
its for low-income individuals, that would ameliorate any undesirable changes in the
distribution of the tax burden.”38 While such credits can offset the adverse impact
on those receiving the credits—and even “overcompensate” the lowest-income
households—they do nothing to offset the reduced progressivity that arises for all
taxpayers above the credit phase-out level.39 In order to neutralize the regressivity
of the shift in tax mix, PIT rates would need to be cut by decreasing amounts as one
moves up the income scale; in other words, the PIT rate schedule would need to be
more steeply inclined. Our later analysis examines this issue, something that none
of the advocates of shifting the tax mix has properly identified.

Another argument used by some advocates of both the tax-mix shift and the PIT
base reform is that the distributional impacts should be assessed in a lifetime, rather
than an annual, framework.40 Yet this argument can at best reduce the degree of
regressive impact from the tax reform; it cannot eliminate it. In an analysis of this
issue, Don Fullerton and Diane Lim Rogers reported that “a tax that is progressive
in an annual sense is also progressive (although less so) in the lifetime perspective.
Similarly, annually regressive taxes are merely less regressive on a lifetime basis.”41

36 André Decoster, Jason Loughrey, Cathal O’Donoghue, and Dirk Verwerft, “How Regressive
Journal of Policy Analysis and Management 326-50. Their study reported that indirect taxes,
including excise taxes and broad value-added taxes (VAT), were regressive with respect to
disposable incomes (because of savings patterns) but progressive with respect to annual
expenditures (because of exemptions and zero-rating of necessities).
37 This proposal has been made by, among others, Duclos and Gingras, supra note 6; McKenzie,
supra note 15; Dahlby, supra note 12; and Bazel and Mintz, supra note 19.
38 Dahlby, supra note 12, at 8.
39 In a revenue-losing variant of a mooted Alberta sales tax that included a refundable tax credit,
McKenzie, supra note 15, found that although the lowest income classes could be insulated from
losses, the gains from the reform still were skewed strongly in favour of higher income groups.
Also see supra note 20.
40 This argument has been made by, among others, Dahlby, supra note 10, and Busby and Laurin,
supra note 20. We later offer further comments on lifetime measures of tax incidence.
41 Don Fullerton and Diane Lim Rogers, “Lifetime Versus Annual Perspectives on Tax Incidence”
An earlier study by Davies et al. based on Canadian tax data had reached the same conclusions. Thus, regardless whether one wishes to assess tax incidence on the basis of annual or lifetime impacts, all of these proposals would reduce the tax system’s progressivity.\footnote{James B. Davies, France St-Hilaire, and John Whalley, “Some Calculations of Lifetime Tax Incidence” (1984) 74:4 American Economic Review 633-49. By some estimates, the overall Canadian tax system is roughly proportional above the lowest incomes (Frank Vermaeten, W. Irwin Gillespie, and Arndt Vermaeten, “Tax Incidence in Canada” (1994) 42:2 Canadian Tax Journal 348-416), in which case these proposals would incline it toward regressive.} None of the economic analysts promoting the lifetime perspective has offered quantitative estimates of the degree to which that view would ameliorate the regressivity problem.

Our analysis of proposals to shift Canadian taxes further toward consumption will examine the implications of applying the condition of distributional neutrality as well as revenue neutrality. These conditions are not simply academic constructs but have relevance to the political economy of real-world tax reforms. If reform is not undertaken on a distribution-neutral basis and, as a result, high earners obtain disproportionate tax relief, it is also unlikely in practice to be revenue-neutral. Middle and moderate earners will resist attempts to increase their own tax burdens, and they will be most strongly opposed if they see high income earners enjoying greater tax relief. Thus, without distributional neutrality, overall tax revenues are likely to decline, and with a progressive tilt to total public expenditures, the poor, the vulnerable, and lower earners are likely to suffer the most from the resulting spending cuts. Because of this political process, distributional neutrality plays a central role in the assessment of proposed reforms.

**THE PERSONAL INCOME TAX BASE**

While Canada’s direct tax on individuals is called a personal “income” tax, its base is in fact much closer to consumption than to income for the great majority of taxpayers.\footnote{This point is acknowledged by Larry F. Chapman and Jack Mintz, “Personal Income Taxation,” in Heather Kerr, Ken McKenzie, and Jack Mintz, eds., *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012), 4:1-33, at 4:11: “Generally, many low- and middle-income taxpayers who own a house and retirement assets are taxed on an expenditure basis since they may have little other capital income subject to tax.”} The reasons for this are a host of provisions for deferring tax on savings and exempting capital incomes from tax, and reduced rates of tax on particular types of capital incomes. As a result, the personal tax base bears relatively heavily on labour earnings and relatively lightly on savings and capital incomes. This situation has major implications for proposals to shift the tax mix away from the PIT and toward indirect taxes on consumption, or to shift the PIT base further toward consumption, since the PIT base is already close to consumption. The exceptions are the highest earners and wealth holders, for whom the use of consumption tax treatment in the PIT is more restricted. This point also explains why the proposed tax reforms would...
extend disproportionate benefits to top earners and why distributional impacts pose concerns. We next describe the major methods by which the Canadian PIT base approaches consumption.

**Tax-Deferral Method**

Tax deferral is a basic method for sheltering savings from income tax treatment in the PIT for Canada and most other countries. The ostensible purpose is to encourage personal savings for retirement by deferring tax on a portion of labour earnings that are saved and applying tax only when the funds are withdrawn to finance spending. Since the definition of “income” for economic and tax purposes is

\[
\text{Income} = \text{Consumption} + \text{Saving},
\]

rearranging the income formula yields

\[
\text{Consumption} = \text{Income} - \text{Saving}.
\]

This second formula describes the tax-deferral method of implementing a consumption-based tax: take total income and allow a deduction for saving. When the individual withdraws savings, or “dissaves,” that amount is added to his income for a measure of current consumption. Beyond deferring tax on the amounts saved, this method also eliminates the effective tax on the normal rate of return earned in tax-deferred accounts.

Canada’s largest vehicles for tax-deferred savings are the individual RRSP and the workplace-based RPP. Relative to income tax treatment, these schemes are estimated to have reduced federal revenues in 2011 by $9.9 billion and $15.6 billion, respectively. To avoid unlimited tax relief for the highest earners, the PIT limits the amount of savings afforded tax-deferred treatment. The ceiling is 18 percent of the individual’s “earned income”—which includes net rental income, net business income,

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44 The tax-deferral method is sometimes called cash flow taxation. Most analysts would restrict assets such as closely held businesses to tax-deferral treatment (and exclude them from tax-prepaid treatment) on account of the ease of shifting factor payments between wages and returns to capital.

45 In the second formula, dissavings are negative savings, and because of the negative sign, they enter as an addition to income for tax purposes.

46 Additional tax-deferral vehicles in the PIT are the deferred profit-sharing plan (DPSP) and the registered retirement income fund (RRIF). Individual pension plans also offer small-business owners, incorporated professionals, and senior executives greater opportunity to make tax-deferred savings than is provided by RRSPs (Marie-Eve Gosselin and Jean-Pierre Laporte, “A Review of Individual Pension Plans,” Personal Tax Planning feature (2013) 61:1 Canadian Tax Journal 257-78).

and gross employment earnings—with an annual dollar limit of over $23,000 in 2013.\textsuperscript{48} Any entitlement that the individual does not utilize in a given year can be carried forward for use in future years. For an individual who contributes to a tax-deferred scheme at the full 18 percent of earned income, the dollar ceiling equates to annual earnings of nearly $130,000. Thus, anyone earning less than that amount is currently unconstrained in his or her ability to save on a consumption-tax basis unless the individual’s saving rate is extremely high,\textsuperscript{49} and proposals to raise the dollar ceiling would potentially affect only the fewer than 4 percent of tax filers with annual earned incomes above that amount.\textsuperscript{50}

Indirect sales taxes such as the federal GST, the federal-provincial HST, and provincial retail sales taxes also use the deferral method for taxing consumption. No sales tax is paid when the funds are initially earned through labour or business, no sales tax is applied to accruing investment income, and sales tax applies only when the initial funds plus accrued investment returns are finally spent. Thus, proposals to shift the overall tax mix away from the PIT and toward greater use of sales taxes will also shift the basis for taxation toward consumption to the extent that the PIT contains partial elements of income tax. However, to the extent that the PIT is already highly consumption-based for the great majority of taxpayers, this shift entails a relatively small move toward consumption taxation except for top earners.

Tax-Prepayment Method

The tax-prepayment method\textsuperscript{51} of applying consumption taxation derives from the decomposition of income into its two main components:

\[
\text{Income} = \text{Income from labour} + \text{Income from capital.}
\]

By exempting from tax the income from capital—which represents the return on savings—the taxation of labour income alone is equivalent to consumption taxation.

\textsuperscript{48} For 2013, the dollar limit for RRSP contributions is $23,820 based on income in the previous year, and the dollar limit for RPP contributions is $24,270. An individual’s total limit is based on his or her RRSP plus RPP contributions plus the employer’s RPP contributions on the employee’s behalf.

\textsuperscript{49} If total federal plus provincial income taxes plus employee contributions for Canada Pension Plan and employment insurance are about 30 percent of gross income at the $130,000 earning level, the 18 percent limit equates to a savings rate exceeding 25 percent of disposable income (0.18/0.7).

\textsuperscript{50} See table 2 below for the distribution of tax filers by total income assessed on their returns.

\textsuperscript{51} We use the terms “tax prepayment” and “tax-prepaid,” while some other analysts have used the terms “exempt-yield,” “tax exemption,” and “wage tax.” In concept, while tax prepayment has some equivalence to tax deferral, the two methods can yield different outcomes when the tax rate differs between the point of contribution and the point of withdrawal of funds. In Canadian practice, the two methods also differ because TFSAs allow recontribution of withdrawals while RRSPs do not.
In effect, the tax on future consumption is “prepaid” when the funds are initially earned. However, unlike the tax-deferral method, tax prepayment relieves from tax not only the “normal” rate of investment return but also any “supernormal” returns. In contrast, the tax-deferral method taxes the full return to capital including any supernormal component at the time of expenditure; it also implicitly subsidizes savings that yield a subnormal rate of return, so that the net effect on aggregate tax revenues will be minimal.52 The prepayment method can be simply applied within a direct PIT, although the desire to limit the extent to which individuals can access such tax-favoured savings requires the use of designated accounts.

The TFSA introduced in 2009 is Canada’s primary formal vehicle using the tax-prepayment method.53 The TFSA grants individuals an annual $5,500 contribution entitlement, with any unused room being carried forward for use in future years. Contributions receive no PIT deduction, but accruing investment returns are tax-free, as are any subsequent withdrawals. The provision of TFSSs means that even fewer higher earners are subject to taxation on their investment incomes, although most higher earners find it advantageous to exhaust their RRSP and RPP limits prior to making TFSA contributions.54 Savers with low and moderate incomes face nil or low effective PIT rates, reducing the value of deductions for tax-deferred savings and thus making TFSSs relatively attractive for this group. However, the current TFSA limit is more than adequate for most savers at low and middle incomes, so that the primary beneficiaries of proposals to raise TFSA limits would be the highest earners and wealth holders. Taking account of both the RPP and RRSP limits and the $5,500 annual TFSA allowance, and assuming saving at 15 percent of gross earnings, consumption tax treatment extends to annual earnings of $195,000, excluding less than 2 percent of tax filers under the current system.55

The tax-prepayment method is also applied with the lifetime capital gains exemption of $750,000 for qualified small business corporation shares and eligible farm properties. Note that this tax exemption can shelter the savings from labour


53 Registered educational savings plans (RESPs) permit no deduction for contributions, but tax on the investment returns is deferred and applied only at the rate of the recipient (who normally can claim tax credits for tuition and related educational expenses to offset the tax liability). Thus, to the extent that little or no tax may be due upon withdrawal, RESP plans approach tax-prepaid treatment.

54 Of course, over a long transition period, more higher earners will be subject to income taxation on their non-tax-sheltered wealth accumulated prior to the introduction of TFSSs.

55 The 2013 limits for RRSPs plus TFSSs also equate to a saving rate of more than 23 percent of net income after reckoning the taxes and other payroll deductions at $195,000 of gross income.
earnings embedded in the value of the property as well as the returns to capital per se. Another major, albeit informal, saving vehicle enjoying tax-prepaid treatment is owner-occupied housing in Canada; not only are capital gains upon the sale of a principal residence tax-free but so are the implicit incomes in the form of rent-free housing services. Similarly, the imputed incomes derived from the services of consumer durable goods such as household furnishings, appliances, and cars are free of PIT and thus consumption-taxed via the tax-prepayment method.

**Reduced-Tax Method**

For individual holdings of financial assets outside RPPs/RRSPs/TFSAs, business assets, and other real assets besides homes, the Canadian PIT offers further departures from income tax treatment that move the base toward consumption. First, capital gains on most financial and real assets are taxed at rates that are just half of the individual's marginal PIT rate, and this tax is deferred—often for many years—until the year of sale. This treatment moves such gains substantially from income toward consumption using the tax-prepaid method. Second, dividends received from Canadian corporations (other than through tax-sheltered accounts) are granted dividend tax credits that significantly reduce the PIT burden. While these credits are intended to avoid the “double taxation” of dividends at the corporate and individual levels, in a small open economy such as Canada the corporate tax is likely borne mostly by consumers of non-tradable services and less mobile productive factors such as workers and resource assets. Thus, shareholders are reimbursed at the PIT level for corporate income taxes that they may not actually be bearing. Third, the Canadian PIT allows relatively unrestricted deductions of interest cost for leveraged holdings of financial assets; this can move the system further beyond a neutral consumption base to one that subsidizes rather than penalizes savings (which is like a negative tax on investment income).

**Effective Tax on Capital Income**

This panoply of PIT provisions that move the base toward consumption through various methods greatly reduces the effective taxation of capital income at the individual level. A study based on 1996 Canadian income tax returns found that “only

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56 Capital gains tax is applied to nominal gains, but for most high-wealth individuals, the value of the half-rate of tax plus deferral far outweighs the lack of indexation in periods of moderate inflation such as we have seen in recent decades.

57 Foreigners are the marginal source of investment funds in corporate Canada, and they do not obtain the benefit of Canadian dividend tax credits. Moreover, Canadian subsidiaries of foreign corporations typically get tax credits from their home country for their Canadian corporate taxes.

about a quarter of personal investment income is subject to income tax,” with the balance receiving consumption tax treatment. This estimate would be further reduced by considering subsequent developments, namely,

- reduction of the capital gains tax inclusion rate from 75 percent to 50 percent;
- an increase in the dollar limits for RPP/RRSP contributions of about 70 percent versus a roughly 45 percent increase in average weekly earnings; and
- a 50 percent hike in the lifetime capital gains exemption in 2007.

Updating the earlier finding would likely yield a figure below 20 percent of personal investment income now subject to income tax, making the PIT fairly close to a consumption-based tax except for the highest earners and greatest wealth holders. This figure will decline further as holdings in TFSAs mount over time. One projection, by Kevin Milligan, is that a mature TFSA system will result in “[o]nly a very small share of Canadians [facing] taxation on their marginal savings decision.” Milligan further projects that after 20 years with a doubled annual TFSA limit of $10,000, only 3.3 percent of households would face any PIT on their capital income from savings.

In addition to making financial investments, individuals can direct their savings to human capital in the form of education and training. Investments of both kinds are key determinants of productivity and economic growth, and thus any disincentives posed by the fiscal system may raise concerns. The major costs borne by the individual in human capital investment are forgone earnings for the time spent and out-of-pocket costs for tuition, fees, and related expenses. Net costs to the individual are affected by the tax treatment of each of these items, plus the subsidies implicit in public funding of education and training and explicit subsidies in the form of grants, bursaries, and scholarships. Forgone earnings are given the equivalent of an immediate writeoff as under a consumption-based tax. However, a net tax burden arises in that the future increased earnings from the investment will be taxed at a

60 The measure of personal investment income used in the study by Poddar and English, ibid., included interest, dividends, capital gains, and imputed rents on homes.
61 In table 2 below and the related text, we present more recent evidence of and discussion about the high concentration of taxable financial incomes in the highest income brackets.
63 Ibid.
64 Because of the relatively low earnings that most students forgo, and the consequent low tax rate that would apply to those earnings, this treatment is less favourable than allowing students to capitalize their forgone earnings and deduct them in future years of higher earnings post-graduation.
higher rate. An analysis for Canada in 2006 found that the effect for most individuals was a small net subsidy for post-secondary education, with stronger incentives for females. Thus, the PIT provisions along with public subsidies already yield a system operating much closer to a consumption tax than an income tax for savings invested in human capital.

CRITICAL REVIEW OF THE ECONOMIC EVIDENCE

In essence, the consensus expert view in Canada is that shifting the tax mix further toward consumption-based sources or making the PIT base more consumption-oriented would yield the following benefits:

- improved incentives for working and labour force participation;
- improved incentives for saving and thus greater aggregate savings;
- increased real investment resulting from greater savings;
- increased economic efficiency and growth;
- greater horizontal equity across individuals over their lifetimes; and
- improved tax compliance through reduced avoidance and evasion.

In assessing these claims, we must keep in mind that the distinction between an income-based tax and a consumption-based tax is not synonymous with the difference between direct and indirect taxes. A direct personal tax can embody consumption-base principles, as we have shown that the Canadian PIT already does to a great extent. In this section, we provide a critical review of the economic evidence for each of the benefits listed above, and for most we find the consensus expert claims to be either much weaker than asserted or entirely lacking.

A general issue in assessing the economic evidence on several of the consumption-tax advocates’ assertions is their relevance to Canadian tax policy. As we have indicated, and as we shall document further in the discussion below, Canada’s PIT already approaches a consumption base for about 98 percent of taxpayers. Only the top 2 percent of earners face substantial PIT burdens on their capital-source incomes, and their capital gains and dividends already enjoy favourable tax treatment relative to a pure income base. As a consequence, most of the findings of existing economic research have limited, if any, applicability to Canadian tax policy. Theoretical economic

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66 Twenty years ago, an Australian economist concluded that “[a] tax mix change offers little in the way of efficiency gains in work versus leisure decisions and in intertemporal consumption choice decisions, to the aggregate level of savings and work effort, and to countering tax evasion and avoidance” (John Freebairn, “Economic Arguments for a New Consumption Tax” (1992) 3:1 Economic and Labour Relations Review 14-35, at 33); also see Jonathan R. Kesselman, “Role of the Tax Mix in Tax Reform,” in John G. Head, ed., Changing the Tax Mix (Sydney: Australian Tax Research Foundation, 1986), 49-94, for similar conclusions.
models use stylized assumptions and compare pure income and consumption tax bases rather than Canada’s hybrid PIT base, which embodies extensive consumption features. Similarly, many empirical economic studies use cross-national data, and their findings that the PIT is less conducive to growth or efficiency than value-added taxes (VAT) like Canada’s GST are contingent on the heterogeneous PIT bases of various countries, many of which are more income-oriented than Canada’s PIT.

**Work Incentive Effects**

Individuals face a choice in allocating their time between working for money income and undertaking unpaid non-market production and leisure activities. If employees’ earned income is taxed while leisure time and home production are not, this provides an incentive for choosing less work time and more leisure and non-market time. A common assertion—both by economists and by tax advocates—is that a direct tax on personal income is therefore more adverse to work than an indirect tax on consumption. As Glen Hodgson writes, “[m]ost economists agree that a shift in personal taxation away from income taxes and toward consumption taxes, such as the GST, would improve incentives to work.”

This assertion is then used as one justification for shifting the tax mix away from PIT and toward greater use of indirect consumption taxes such as GST/HST. Reduced reliance on income taxes, it is argued, will provide more neutral incentives for how individuals allocate their time, and thus will improve economic efficiency.

The deficiency of this assertion is that it ignores the work disincentive effects of any indirect tax on consumption. A consumption tax is also effectively a tax on work, because most people get most of their income from working, and they use most of this income to purchase goods and services. Their incentive to work is determined by the amount of real goods and services that their income provides for them. An increase in the rate of GST/HST means that each hour of work provides less purchasing power, so that it reduces the incentive to work just as an increase of income tax would. Only if individuals are subject to a “tax illusion,” such that they consider their nominal net-of-PIT income but ignore the impact of GST/HST on their real purchasing power, will a tax-mix shift yield improved work incentives. None of the extensive research on labour supply behaviour has uncovered any such tax illusion.

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67 Hodgson, supra note 11, at 6. Similar recent statements include Mintz, supra note 18, and Laurin and Robson, supra note 13.

68 To the extent that part of the earnings from work are saved, the consumption tax does not impose any immediate burden, but this is offset by the future tax that will apply to consumer spending out of those savings and the accumulated investment return to the savings.

69 Kesselman, supra note 66.

Typical empirical analyses of labour supply include in the “tax wedge” both the direct tax on labour income and the indirect tax on consumption spending out of those earnings.\textsuperscript{71} A study for the Mirrlees taxation review in the United Kingdom concluded that “shifting the balance of taxation towards VAT cannot be expected to have a great impact on work incentives or levels of employment.”\textsuperscript{72}

A consumption-based tax can actually impose greater work disincentives than an income-based tax that raises the same concurrent level of revenues. A broad tax base of income (with few exempt receipts) is larger than a broad consumption base (with few exempt goods and services), since income equals consumption plus savings, and aggregate savings are positive. Therefore, to raise the same amount of revenues, a consumption-based tax must apply a higher tax rate than is required for an income-based tax; this higher tax rate is more distorting to the choice to work and thus has greater work disincentives.\textsuperscript{73} This potential superior efficiency of an income tax in the labour market is offset by the superior efficiency of a consumption tax in the capital market related to non-distortion of saving behaviour. If one is willing to consider the future revenues that the savings will generate when ultimately spent under a consumption-based tax, the inferiority of such a tax in terms of work incentives is reduced but not eliminated.\textsuperscript{74}

Sometimes advocates of consumption-based taxation argue its superior work incentives by conflating changes in overall tax progressivity with changes to the tax base. A progressive tax-rate schedule will impose higher marginal rates on higher income earners, and this is potentially more distorting to their work incentives. Advocates for a “flat tax” formulated as a direct tax on consumption have made strong assertions about the increased work effort and entrepreneurial activity that would result.\textsuperscript{75} This type of tax reform is clearly not distributionally neutral, since it provides large relief with respect to taxes and tax rates for the highest earners. Hence, any resulting increase in work incentives for highly paid workers would come at the

\textsuperscript{71} For example, see Lee Ohanian, Andrea Raffo, and Richard Rogerson, “Long-Term Changes in Labor Supply and Taxes: Evidence from OECD Countries, 1956-2004” (2008) 55:8 Journal of Monetary Economics 1353-62, at 1356, where the tax rates on labour income ($\tau_i$) and consumption spending ($\tau_c$) enter in symmetrical fashion in the formulation of the tax wedge as $1 - \tau = (1 - \tau_i)/(1 + \tau_c)$.


\textsuperscript{73} Chapman and Mintz, supra note 43, at 4:10.

\textsuperscript{74} The present value of tax revenues for the income-based tax will still exceed that for an equal-rate consumption-based tax, on account of the taxation of investment income.

expense of reduced progressivity.76 Similarly, a shift in the tax mix from the PIT to greater reliance on the GST could increase work incentives only if the effective PIT rate cut for some workers exceeded their effective the GST rate increase—that is, if they gained at the expense of other taxpayers. As observed in a report by the Organisation for Economic Co-operation and Development (OECD), “if a move towards [indirect] taxes on consumption [from PIT] would increase incentives to work, it would also increase inequality.”77

Effects on Personal Savings

A major assertion by advocates of making the tax system more consumption-oriented (through either of the two reforms) relates to improved incentives for personal savings. By reducing the effective tax on investment income or shielding savings from tax until consumed, the proposed reforms are believed to increase aggregate savings. Yet the economic theory of saving behaviour entails offsetting substitution and income effects of changes in the tax rate on investment income. Reducing the tax rate on investment income raises the net-of-tax return to saving; this poses a substitution effect that makes future consumption more attractive relative to current consumption and thus encourages greater savings. But the reduced tax rate also exerts an income effect, in which the individual feels wealthier and thus tends to increase current consumption, with the result that less is saved out of current income. Without empirical evidence, one cannot tell which of these two theoretical effects dominates.78 Moreover, many individuals are “target savers,” meaning that they have a targeted level of savings at retirement. Reducing the tax rate on their investment income means that they will need less saving over the years to reach their target, so that reduced tax actually reduces saving.

Empirical studies of the effects of taxation on personal savings have been beset by complexities of both methodology and data, and they have yielded findings that vary and are sometimes inconclusive, but seldom are large in magnitude. A major review of the subject concluded with the caveat that “one cannot review the voluminous literature on taxation and saving without being somewhat humbled by the enormous difficulty of learning anything useful about even the most basic empirical

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78 If the reform is distribution-neutral, this can offset the income effect, so that the substitution effect should prevail; but a wealth effect can reduce saving. Also see Christopher Ragan, “Progressive Income Taxes and the Substitution Effect of RRSPs” (1994) 27:1 Canadian Journal of Economics 43-57, for analysis of how RRSPs within a progressive PIT can yield a substitution effect that decreases saving.
questions.79 Another analyst also warns that a “potentially serious concern is that individual saving behavior is far more erratic than economic simulation models predict.”80 The most methodologically rigorous analysis of this issue, based on unique Danish data, yields two key findings on the effects of enhanced tax incentives:81 (1) enhanced incentives have a minimal impact on savings for the 85 percent of individuals who are “passive” savers; and (2) for the 15 percent who are “active” savers, the response is primarily to shift assets between taxable and tax-favoured accounts rather than to increase their total saving. A recent review of the issue for the Mirrlees taxation review similarly found that “it is unlikely that changes in interest rates due to preferential taxation or other movements to interest rates, will cause big changes in the level of saving.”82 Thus, the proposed tax reforms are unlikely to induce much, if any, additional personal saving.

Effects on Business Investment

Policy interest in the savings effects of tax reforms stems from the implied impacts on business investment in the Canadian economy. Empirical analysis of cross-country experience has found a substantial association between a country’s domestic savings and its real investment.83 However, this linkage between domestic savings and domestic investment is less than complete and has been weakening over time. International capital flows are extensive particularly for countries such as Canada, through both portfolio and direct investment.84 At the margin, business investment

82 Orazio P. Attanasio and Matthew Wakefield, “The Effects on Consumption and Saving of Taxing Asset Returns,” in Dimensions of Tax Design, supra note 72, 675-736, at 728.
84 For evidence regarding Canada in particular, see the findings in P.C. Afxentiou and A. Serletis, “International Capital Mobility and the Long Run Investment and Saving in Canada” (1993) 46:2-3 Economia Internazionale 147-67; also see Florian Pelgrin and Sebastian Schich, National Saving-Investment Dynamics and International Capital Mobility, Bank of Canada Working Paper 2004-14 (Ottawa: Bank of Canada, April 2004). These studies suggest an incomplete linkage between domestic savings and domestic investment levels.
in Canada will be determined by investors who have a reasonable sense of the risk-adjusted rates of return in different countries, taking into account the taxes on business profits (which apply in the host country) rather than taxes on personal income (which apply in the home country). Even if the proposed reforms were to significantly raise personal savings, these are just one component of total domestic savings, which include savings in the business sector and the net savings of the governmental sector (the budgetary surplus or deficit).

The linkage between personal savings and business investment is further weakened by research finding that the marginal source of funds for most corporate capital investment is retained earnings rather than new stock issuance to investors. This view has been tested empirically and verified with respect to the taxation of dividends. Therefore, even if cutting the tax rate on dividends or capital gains increased the value of stock prices, it would have little effect on capital investment. This view is reinforced by the finding that dividend taxation has relatively little impact on stock prices. This outcome has been empirically confirmed for Canada, where marginal investors are foreigners or pension funds, entities that are not affected by Canadian taxes on dividends. In the period since 1999, business capital investment in Canada has been consistently less than corporate gross savings. Since 1985, personal savings also have displayed no discernible relationship to business capital investment in Canada. Thus, business investment—at least for mid-sized and large firms—evidently is not constrained by the supply of savings from the household sector.

Firms in Canada’s small-business sector cannot readily access the public capital markets or internationally mobile capital available to large firms. Those factors could mean that any increased personal savings resulting from the tax reforms would raise investment in small businesses. However, smaller enterprises already enjoy favourable treatment through very low corporate tax rates, which allow them to retain earnings and pay taxes on those earnings at rates much lower than the PIT rate on distributions. Subsequently, these retained earnings can be taken from the


87 Statistics Canada CANSIM tables 378-0019, “Financial Flows, Corporations and Government Business Enterprises” (corporate gross savings defined as retained earnings plus capital consumption allowance), and 380-0002, “Gross Domestic Product (GDP), Expenditure-Based” (business capital investment). In fact, the gap is even larger, since investment includes spending by unincorporated firms whose profits are not included.

88 Statistics Canada CANSIM tables 380-0004, “Sector Accounts, Persons and Unincorporated Businesses” (savings in the household sector), and 380-0002, “Gross Domestic Product (GDP), Expenditure-Based” (business investment).

89 Unincorporated small businesses are typically even less efficient in scale than corporate small enterprises and already enjoy various favourable tax advantages.
company completely free of tax via the lifetime capital gains exemption. These provisions represent a subsidy to small corporations relative to their larger rivals, and this induces an inefficiently excessive share of investment flowing to a sector that has lower productivity and lower worker compensation. The large share of small business in the economy has been identified as a primary cause of lower productivity in Canada.90 Thus, any additional tax inducement increasing investment in small business would likely be adverse for the overall economy.91

**Economic Efficiency and Growth Effects**

Our preceding analysis of work, savings, and investment effects casts doubt on the ability of consumption-oriented tax reforms to significantly raise the economy’s efficiency or growth. However, that analysis does not encompass more subtle effects such as the sectoral composition of investment or intertemporal resource allocation. Various theoretical models and empirical strategies have sought to include these effects, and Canadian economists and policy analysts advocating consumption-based tax reforms have been strongly influenced by such research. Many of these studies forecast significant economic gains from shifting taxes toward consumption. Nevertheless, because these studies are overwhelmingly based on foreign or cross-country data, applying their findings to the Canadian context is hazardous. Here we refer readers to reviews of the literature92 and identify problematic aspects of the assumptions and policy implications of a number of these studies. Moreover, consumption tax advocates frequently cite quantitative estimates from two studies based on Canadian data, and we assess the reliability of those studies’ policy implications.

Much of the widespread support among economists for consumption-based taxation stems from early theoretical analyses finding that zero taxation of capital income

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91 Other standard proposals to increase the PTT’s consumption basis—such as expanding access to tax-deferred (RRSP) and tax-prepaid (TFSA) savings—have restrictions on the ability to invest in shares of closely held businesses. These restrictions are well justified on grounds of preventing avoidance through the sheltering of labour earnings of owner-proprietors along with their capital returns. (A consumption-based tax is not intended to shelter labour income.)

is optimal. Yet, in a comprehensive review of this research for the Mirrlees taxation review, James Banks and Peter Diamond conclude that considering additional factors undermines the earlier findings and implies that some taxation of capital income is optimal. Among the factors that they cite are the interaction between leisure and intertemporal preferences, initial wealth holdings, non-marketed risks, age-dependent characteristics, different saving propensities across earnings types, permanent-income uncertainty, and diverse aspects of saving behaviour. These challenges to the theoretical presumption of the optimality of consumption-based taxation support a continuing role for income-based personal taxation in the overall revenue system.

Additional issues weaken the relevance of much previous research to Canada. First, the theoretical studies typically compare pure income-based to pure consumption-based taxes, and the empirical studies do not distinguish the varying degrees to which the PITs of various countries are already consumption-based. Thus, these studies do not account for the large extent to which the Canadian PIT already embodies a consumption base. Second, intersectoral distortions between the business and housing sectors may be muted by a shift toward consumption, but this feature is lacking in most modelling and not properly controlled in estimation. For example, the Canadian tax treatment of home equity is less favourable than the treatment in the United States. Third, the relative openness of the Canadian economy to trade and financial flows is omitted from most theoretical models and empirical cross-country estimates. But, as stressed by one economist, “to the extent international capital markets are competitive, models that ignore international capital flows may give very misleading results regarding the relative efficiency properties of income and consumption taxes.”

Two further issues affect the applicability of research findings to practical tax policy reforms whether in Canada or elsewhere. First are findings that the PIT’s rate progressivity—rather than its income base—is responsible for much of the reduced economic efficiency or growth relative to flat-rate indirect taxes on consumption.

93 James Banks and Peter Diamond, “The Base for Direct Taxation,” in Dimensions of Tax Design, supra note 72, 548-648. Other recent economic analyses have also concluded that some taxation of capital income is optimal, for a variety of reasons. For example, see James B. Davies, Jinli Zeng, and Jie Zhang, “Time-Consistent Taxation in a Dynastic Family Model with Human and Physical Capital and a Balanced Government Budget” (2009) 42:3 Canadian Journal of Economics 1023-49, at 1023, concluding that “a consumption tax . . . can be improved on by taxing capital income more heavily than labour income.”


95 Reviews of the theoretical and empirical literature find that the PIT’s rate progressivity explains at least part of its estimated more adverse impact on growth: Myles, supra note 92; Arnold, ibid.; and Johansson et al., ibid. Modelling by Fullerton and Lim Rogers, supra note 32, at 339, reaches a contrasting conclusion that “any enhancement of progressivity involves little apparent efficiency loss.”
Thus, any economic gains in shifting from the PIT to indirect taxes arise at the cost of adverse distributional impacts. Second is the fact that most of the efficiency gains predicted in models for tax shifts from income to consumption arise from the implied capital levy on existing wealth at the time of the reform; this mainly has an impact on retirees and older workers. Politically feasible tax reforms would contemplate some compensation to losing groups during the transition, and this would consume part of the revenues that would otherwise augment economic efficiency.\footnote{Louis Kaplow, “Capital Levies and Transition to a Consumption Tax,” in Alan J. Auerbach and Daniel N. Shaviro, eds., \textit{Institutional Foundations of Public Finance: Economic and Legal Perspectives} (Cambridge, MA: Harvard University Press, 2008), 112-46, critically assesses this capital levy aspect of imposing a consumption tax.}

As Alan Auerbach has concluded,

> there are large potential economic gains from a move to consumption taxation . . . [but] much or even all of these gains evaporate when progressivity is maintained and transition relief is provided to owners of existing assets.\footnote{Alan J. Auerbach, “Comment,” in \textit{Taxing Capital Income}, supra note 80, 83-88, at 86-87.}

Lim Rogers expounds on this view:

> [T]he efficiency gains from a consumption tax . . . from even a purist’s version (with perfect flatness and a pure consumption base) are rather modest—almost certainly no more than one percent of lifetime income. . . . Deviations from the pure version, in the form of either transitional relief or enhancements to progressivity, can reduce still further the size of efficiency gains.\footnote{Diane Lim Rogers, “Sorting Out the Efficiency Gains from a Consumption Tax,” in \textit{Proceedings of the Eighty-Eighth Annual Conference on Taxation} (Columbus, OH: National Tax Association-Tax Institute of America, 1996), 40-46, at 45.}

In short, economists’ estimates of the efficiency or growth gains from shifting the tax system toward consumption are highly sensitive to the assumptions and methodology, implying much uncertainty about the size or even the existence of such gains.

A Department of Finance working paper by Maximilian Baylor and Louis Beauséjour is most frequently, and uncritically, cited by Canadian analysts advocating increased reliance on consumption taxes.\footnote{Maximilian Baylor and Louis Beauséjour, \textit{Taxation and Economic Efficiency: Results of a Canadian CGE Model}, Working Paper 2004-10 (Ottawa: Department of Finance, November 2004). The findings of this study have been cited by, among others, the Institute for Competitiveness & Prosperity, supra note 9; Clemens et al., supra note 10; Dahlby, supra note 12; and Hodgson, supra note 11. The study’s findings have also been highlighted in federal budget papers.} This model is used to simulate the gains in
economic welfare\textsuperscript{100} from cutting various types of taxes by $1.00. These are estimated to be about $1.30 for tax cuts on capital (whether by raising capital cost allowances, cutting PIT on capital incomes, or cutting sales taxes on capital investment); $0.37 for corporate income taxes; $0.32 for PIT (a blend of tax on capital income and mostly labour income); $0.15 for payroll and labour income taxes; and just $0.13 for consumption taxes, such as the GST/HST, that do not strike business capital. Relying on these results, many Canadian analysts have inferred that substantial economic gains could be derived by shifting the tax mix toward consumption or by reducing capital income within the PIT base. These results also imply that reducing PIT rates is less advantageous than shifting the PIT base toward consumption, since part of the revenue loss of rate cuts is dissipated on labour earnings.

The reliability of the Baylor-Beauséjour model as a useful guide to tax policy is conditional on various elements in its construction. The model assumes that a very large proportion—nearly 90 percent—of domestic savings is productively invested in Canada.\textsuperscript{101} Our earlier discussion of the Canadian economy’s high degree of international capital mobility casts doubt on this assumption, and as a result the study’s estimates may be greatly overstated. Other aspects of the model may also affect its reliability: it lacks key features such as differentiation between small and large firms, and among age cohorts and particularly retirees; and it lacks a detailed account of the tax and transfer system, such as the extent to which Canada’s PIT already provides consumption-type treatment.\textsuperscript{102} These deficiencies affect the reliability of the model’s estimates of the relative efficiency costs of alternative tax bases. As Auerbach has stated about models of this genre, “[s]imulation evidence to date has not taken into account a variety of issues that could significantly affect the estimated efficiency gains from adopting a consumption tax.”\textsuperscript{103}

A second widely cited set of estimates on the comparative economic efficiency of alternative tax bases in Canada is that of Dahlby and Ergete Ferede.\textsuperscript{104} This research is based on an empirical formulation and thus avoids the tight assumptions

\textsuperscript{100} This is known as the marginal excess burden (MEB) of a tax, where, for example, the estimated MEB of capital taxes is 1.30. The study also provides estimates of the impacts on real gross domestic product (GDP), and these compare in relative magnitudes with the welfare effects (which include the value of leisure).

\textsuperscript{101} Even more crucially, the model does not allow for responsiveness of foreign investors to changes in the net return to Canadian corporate business; if the mooted tax reforms had an impact on Canadian saving and investment in domestic business, this would be offset by reduced foreign investment in Canada, with high capital mobility and an unchanged world rate of return.

\textsuperscript{102} For these points we thank John Lester, an economist who worked at the Department of Finance at the time of the study and contributed to the Baylor-Beauséjour analysis.


\textsuperscript{104} Bev Dahlby and Ergete Ferede, \textit{What Does It Cost Society T o Raise a Dollar of Tax Revenue? The Marginal Cost of Public Funds}, C.D. Howe Institute Commentary no. 324 (Toronto: C.D. Howe Institute, March 2011).
needed in model building; it also reflects the actual hybrid nature of Canada’s PIT base. Dahlby and Ferede reported their findings in the form of the comparative marginal cost of funds (MCF) from each tax base—the real cost to the economy of raising an additional dollar of revenue from a small increase in the associated tax rate.\(^\text{105}\) They estimated the MCF for alternative federal tax bases as follows: corporate income tax $1.71; PIT $1.17; and GST $1.11. Various other studies have used these figures uncritically to argue that a shift in Canada’s tax mix from the PIT to the GST would enhance the economy’s overall efficiency. However, the technical study by Dahlby and Ferede that provides the basis for their estimates indicates that the MCFs of the PIT and the GST do not differ significantly.\(^\text{106}\) This result is not surprising in view of the highly consumption-oriented base of Canada’s PIT, but those advocating a shift in the nation’s tax mix toward the GST have overlooked this point.

**Income Smoothing and Lifetime Equity**

An income-based tax strikes the returns to savings and investment, and in this manner it penalizes saving for future consumption versus spending labour earnings when they are received. This aspect of an income tax has been described as “double taxation” since the earnings are taxed both when received and again on the investment returns to the portion saved. In contrast, a consumption-based tax treats earnings in a neutral fashion whether they are spent immediately or saved for future consumption.\(^\text{107}\) Savings are important to individuals and families in buffering against short-run and transitory variations in labour earnings, thus allowing consumption levels to be smoothed over shorter periods. Savings are also important in facilitating the smoothing of consumption levels between working years and retirement years, with the predictable drop of labour earnings during retirement. Consumption smoothing allows individuals to maximize their well-being over time, given that a smoother consumption path is more highly valued than a fluctuating path with the same average

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105 Roughly speaking, \(MCF = 1 + MEB\), for comparison with the figures reported above for the Baylor-Beauséjour model. For the more precise formulation, see Bev Dahlby, *The Marginal Cost of Public Funds: Theory and Application* (Cambridge, MA: MIT Press, 2008), at 3.

106 Bev Dahlby and Ergete Ferede, *The Effects of Tax Rate Changes on Tax Bases and the Marginal Cost of Public Funds for Provincial Governments*, C.D. Howe Institute Working Paper (Toronto: C.D. Howe Institute, March 2011) (also published with the same title in (2012) 19:6 *International Tax and Public Finance* 844-83). The estimated coefficient on the federal PIT rate in the authors’ preferred specification of their “dynamic personal income tax base regression” is \(-0.305\) with a standard error of \(0.162\) for a \(t\)-value of 1.88, meaning that any reasonable confidence interval would imply an MCF for federal PIT overlapping that of the GST (Dahlby and Ferede, supra, at 13). When this study was later published in a journal, the figure for the MCF of the GST was omitted; one of the study authors explained to us that they felt that their original assumption of equal impact from provincial and federal sales tax rate variations was inappropriate.

107 The consumption-based tax imposes a burden that is equal in present value regardless of when the funds are spent, since the discounting for future consumption exactly offsets the compounding of investment returns, on the assumption that the discount rate is the same as the rate of return.
level. Thus, a consumption-based tax potentially leads to higher levels of individual utility than an income-based tax even with the same total tax burden.

The efficiency gains from consumption smoothing in shifting the tax base toward consumption and the associated impacts on savings are important in assessing such reforms. Dahlby has computed the utility or welfare gains to individuals from moving the tax base to consumption based on a standard economic model of saving behaviour. Using a range of assumed values for the substitutability between current and future consumption and the income elasticity of consumption, most of his estimates imply welfare gains from reduced taxation of capital income but also reduced saving rates. Because the gains would accrue only to persons not already accessing consumption tax treatment—high earners and wealth holders—those persons would enjoy increased utility even if the reform were distribution-neutral in monetary terms. Dahlby’s finding that the affected groups might actually save less in aggregate with the tax reform implies a reduction in the funds for investment, which is the only means by which the rest of society could gain from the reform. Thus, his study suggests the possibility that high earners and wealth holders would gain from the move toward consumption taxation while most others could actually lose in the long run from less economic growth, even if the reform were gauged as distribution-neutral.

Avoidance and Evasion Effects

An incremental shift in the mix toward indirect taxes would yield uncertain gains in tax compliance and no savings in tax administration. Both the PIT and GST/HST would remain in operation, with all of their administrative and compliance burdens. Real-world evidence on the operation of VAT in Canada and abroad reveals that a GST/HST has significant compliance vulnerabilities of its own. Various evasion schemes have emerged such as claims for input rebates on fraudulent exports. Small suppliers of many services and of some goods regularly evade GST/HST by cash sales, barter, and unreported transactions, similar to what happens under the PIT. An empirical study found that overall tax evasion increased with the introduction of Canada’s GST in 1991. The new sales tax provided visible bargaining power by

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108 The relationship between consumption smoothing over time and the measured regressivity of consumption taxes is examined in an analytical model by Kartik B. Athreya and Devin Reilly, “Consumption Smoothing and the Measured Regressivity of Consumption Taxes” (2009) 95:1 Economic Quarterly 75-100.

109 Dahlby, supra note 10, at 84.


111 To the extent that underground activities are sectorally concentrated, general equilibrium analysis suggests that a tax-mix shift will pose little leverage on non-compliance. Jonathan R. Kesselman, “Evasion Effects of Changing the Tax Mix” (1993) 69:2 Economic Record 131-48. See Auerbach, supra note 103, at 25-26, for a simple explanation of this incidence process.

vendors for cash sales from purchasers, and this behaviour is likely to increase with higher GST rates.\textsuperscript{113} A shift in the tax mix toward the GST would allow for reduced PIT rates, but all of the PIT base provisions inducing tax avoidance by high earners would remain in place. While incentives for tax avoidance might moderate with significantly lower PIT rates, on a distribution-neutral basis this would require massive rate hikes for the GST.\textsuperscript{114}

Shifting the PIT base further toward consumption would yield at best limited gains in tax compliance and administration. If undertaken on a distribution-neutral basis, the reform’s effects on tax planning and tax avoidance would be ambiguous. The larger amounts of capital income that received consumption-tax treatment would be freed of incentives for tax avoidance and evasion; these items would also be freed of the need for cost-basis record keeping and tax auditing. Simultaneously, the increased marginal tax rates needed for distributional neutrality would exacerbate tax planning as well as avoidance and evasion incentives for capital incomes that remained taxable. The higher marginal tax rates that also applied to labour and unincorporated business incomes of higher-bracket taxpayers would likely exert disincentives for productive activity and inducement for tax planning and non-compliance. One example is the increased incentive for proprietors to claim more ordinary personal consumption outlays as tax-deductible business expenses.

**DISTRIBUTIONAL EFFECTS OF PROPOSALS**

Two variants of proposals to make the Canadian tax system more consumption-oriented have been advanced: (1) shifting the tax mix away from the PIT and toward indirect taxes like the GST/HST; and (2) shifting the PIT base further toward consumption. While proposals for tax-mix change have clearly articulated revenue-neutral reforms, where the revenue losses from some changes would be fully offset by revenue gains from other components of the reform, this is less common for PIT reform proposals. However, most proposals of both varieties have given inadequate attention to the distributional impacts of the reform, which raise the prospect of decreasing the overall tax system’s progressivity. To begin this analysis, we discuss two methodological issues related to measurement. We then address the likely distributional impacts and the changes needed to make each type of reform distribution-neutral as well as revenue-neutral. We conclude by discussing proposals to mitigate the adverse distributional impacts of moving the PIT base fully to consumption through lifetime wealth transfer taxes.

\textsuperscript{113} The extension of tax to many services under the GST/HST also increases evasion, and several European countries have responded to this problem by reducing their VAT rates on selected services. See Copenhagen Economics, *Study on Reduced VAT Applied to Goods and Services in the Member States of the European Union: Final Report* (Copenhagen: Copenhagen Economics, June 2007).

\textsuperscript{114} This finding will be demonstrated in the next section.
Measurement of Distributional Impacts

A basic issue in measuring the distributional impacts of a tax change is the metric for well-being of individuals or households. Some economists prefer to classify taxpayers by their consumption rather than their income, and others take the further step of utilizing lifetime income. Taking a lifetime perspective provides a more permanent measure that avoids the variations in income that individuals experience over time owing to transitory shocks and life-cycle earnings patterns. However, a lifetime measure places extreme demands on our empirical knowledge and our assumptions about individual behaviour and economic structure. A lifetime measure also ignores many real-world phenomena, including the heterogeneity of individual experiences with temporary or persistent economic shocks; liquidity and borrowing constraints that face most individuals, particularly early in adulthood; and myopia, hyperbolic discounting, and other departures from the economic model of rational behaviour. Neither of these alternative measures accords well with the real world of tax policy making. Public discourse, political campaigns, budget making, and budgetary document presentations are framed almost exclusively in terms of taxpayers’ annual incomes. For all of these reasons, our analysis retains the standard annual income measure, while acknowledging that a lifetime perspective moderates the estimates of progressivity for the PIT and regressivity for the GST/HST.

Tax policies that shift toward consumption—either through PIT base changes or through tax-mix shifts—can affect the real value of wealth holdings at the time of the reform. The simplest example is a hike in the GST rate offset by reduced PIT rates; this raises the tax-inclusive consumer price level and thereby devalues current wealth holdings. However, depending on the form of an individual’s wealth holding, offsetting increases in the value of wealth can occur. For non-tax-sheltered and tax-prepaid wealth, the associated cut in PIT rates provides no such offset; but for tax-deferred wealth, the cut in PIT rates means that withdrawals (which are fully taxable under the PIT) will enjoy increased real value and thus offset the GST-induced increase in price level. Similarly, reforming the PIT toward a consumption base can have varying impacts on an individual’s real wealth, hinging on the form of the wealth holdings. Moreover, when reforms are anticipated, particularly when pre-announced or implemented in stages, the altered expectations about price levels can affect the values of both real and financial assets. Because these wealth impacts are highly heterogeneous and uncertain, we do not include them in our distributional analysis.

115 See, for example, the model-based analysis by Fullerton and Lim Rogers, supra note 32, which simulates the effects of tax reforms using lifetime income measures. Laurence J. Kotlikoff, “Comment,” in Economic Effects of Fundamental Tax Reform, supra note 32, 347-51, severely critiques Fullerton and Lim Rogers’s modelling on the basis of a divergence of views about appropriate structural and behavioural assumptions.
**Distributional Effects: Tax Mix Shift**

The federal PIT in Canada is highly progressive, and this progressivity is needed to offset the proportionality or regressivity of most other revenue sources.\(^\text{116}\) Without the PIT or with a PIT much reduced in relative size, the overall Canadian tax system would be transformed from a roughly proportional pattern to a regressive one. The GST and the HST are both regressive in their annual impact, even with exemptions and zero-rating of several types of consumer necessities.\(^\text{117}\) This regressive pattern is offset for the lowest incomes by the provision of federal and provincial refundable credits. However, the regressive impact of GST/HST resumes for incomes above the modest income levels where those credits phase out. For those willing to take a lifetime perspective on tax incidence, the regressivity of these sales taxes is substantially reduced but not eliminated.

As a result of this differential incidence between the PIT and the GST/HST, a shift of revenues away from the PIT and toward the GST/HST would reduce overall tax progressivity unless the PIT rate cuts were weighted heavily in favour of the lower brackets relative to the upper brackets. This outcome stems in part from the pattern of saving rates, which increase significantly as one moves up the income scale; income that is saved is not spent on consumption and thus does not incur GST/HST. Moreover, the fact that GST/HST applies only to spending out of net-of-PIT incomes combined with the PIT’s progressivity further reduces the scope for reducing PIT rates in the upper brackets when increasing GST/HST rates. If an increase in the GST/HST rate is balanced by distribution-neutral cuts in PIT rates, the latter cuts will vary by the taxpayer’s initial PIT rate bracket and rate of saving (or spending) out of after-tax income.

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\(^{116}\) For extensive critical review of the distributional pattern of PIT and other taxes in Canada and other countries, see Jonathan R. Kesselman and Ron Cheung, “Tax Incidence, Progressivity, and Inequality in Canada” (2004) 52:3 *Canadian Tax Journal* 709-89 and references cited therein, including the classic study by Vermaeten et al., supra note 42. For a review that focuses on the distributional effects of indirect consumption taxes, see Neil Warren, “The Distributional Effect of Consumption Taxes in Tax Systems,” in John G. Head and Richard Krever, eds., *Tax Reform in the 21st Century* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2009), 217-76. Also see *Tax Expenditures and Evaluations*, supra note 47, at 31-47, for findings that the federal PIT is highly progressive and even more so when considering federal refundable tax credits and income-tested benefits. Provincial PITs vary in their degree of progressivity, but many provinces apply a more progressive rate schedule than the federal PIT (Kesselman, supra note 24).

\(^{117}\) Studies have found that the Canadian GST is even more regressive than the manufacturers’ sales tax that it replaced (G.C. Ruggeri and K. Bluck, “On the Incidence of the Manufacturers’ Sales Tax and the Goods and Services Tax” (1990) 16:4 *Canadian Public Policy* 359-73) and that replacing provincial retail sales taxes with the HST likely exerted a further, albeit small, increase in regressivity (Michael Smart and Richard M. Bird, “The Economic Incidence of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience” (2009) 35:1 *Canadian Public Policy* 85-97).
Table 1 displays the distribution-neutral tradeoff between PIT marginal rates and the GST/HST rate\textsuperscript{118} for various assumed initial marginal tax rates ($t_0$) and spending propensities ($A$) out of after-tax income.\textsuperscript{119} For taxpayers at moderate incomes with an initial PIT rate of 20 percent and $A$ at 100 percent (for all spending and no saving), the PIT rate can be cut by 0.80 of 1 percentage point for each 1 percentage point hike in the GST/HST. At the other end of the income spectrum, at an initial PIT rate of 50 percent and $A$ at 75 percent (25 cents of an extra after-tax dollar is saved), the PIT rate can be cut by only 0.37 of 1 percentage point. Consider a distribution-neutral policy reform that aimed to cut the top-bracket PIT rate by 5 percentage points from 50 percent to 45 percent. This reform would require a 13.5 percentage point hike (5/0.37) in the GST/HST rate and would permit the 20 percent PIT bracket rate to be reduced by 10.8 percentage points (13.5 × 0.8), which is more than twice the implied PIT rate cut for the top bracket.

The preceding example illustrates the problems in using changes to the tax mix as a way of reducing upper-bracket PIT rates. Reformers seeking significant cuts in top PIT rates through a tax-mix change are therefore likely to be frustrated unless they also accept massive hikes in GST/HST rates or a regressive shift in the tax burden. This analysis further assumes that all income is subject to PIT, whereas in fact increasing proportions of income are not taxable at higher incomes on account of the consumption-based provisions described earlier. Moreover, the limited difference between the bases of the PIT and the GST/HST—with many consumption elements in the PIT base—implies that any economic gains from shifting the overall tax base would be similarly limited. Because those gains are more likely to assume the form of improved economic efficiencies in lifetime consumption by affected households than to result in increased savings and investment, the real gains would be concentrated among high-income households rather than dispersed more widely.

Even if a tax-mix change with reduced PIT and increased GST/HST were applied in a distribution-neutral manner across income classes, it would still exert redistributive effects in other dimensions. Take the case of three individuals at the same taxable income and with the same amount of wealth but held in different forms. Person A has $100,000 in home equity (or TFSA savings), which is a tax-prepaid asset; person B has $100,000 in an RRSP, which is a tax-deferred asset; and person C

\textsuperscript{118} For more complex formulas of the distribution-neutral rate tradeoff between direct and indirect tax rates that consider additional factors, see Creedy, supra note 34.

\textsuperscript{119} These illustrations ignore the differential tax coverage of the goods and services purchased by consumers at different levels of income. According to Michael Smart, “Departures from Neutrality in Canada’s Goods and Services Tax” (2012) 5:5 SPP Research Papers 1-24, at 8, the “VAT revenue ratio” or proportion of all consumption effectively taxed by Canada’s federal GST in 2008 was 51 percent on average. Owing to exempt and zero-rated items, this ratio is lowest for low-income households, but declines from the fourth to the top quintile (Luc Godbout and Suzie St-Cerny, “Are Consumption Taxes Regressive in Quebec?” (2011) 59:3 Canadian Tax Journal 463-93, at 488) and likely declines further for the top decile and percentile of households because of foreign spending.
has $100,000 in unsheltered financial assets yielding taxable income. The GST/HST also applies the tax-deferred method, so that a distribution-neutral tax shift would leave unaffected person B, the RRSP holder; the reduced PIT rate on RRSP withdrawals would be offset by the increased GST/HST rate on the spending, and both would occur at the same time. The same tax-mix shift would be relatively adverse to person A, since the PIT rate cut would provide no benefit for a tax-prepaid asset that would face no further tax even without the rate cut, yet this individual would be subject to the higher GST/HST rate. The tax-mix shift would be relatively favourable to person C, who would now face a lower PIT rate on income from financial assets that would more than offset the higher GST/HST ultimately incurred on the spending. Similarly, the tax-mix shift would exert differential effects across cohorts at different stages of their life-cycle savings.

### Distributional Effects: PIT Base Reform

The other major means of shifting the Canadian tax system further toward consumption is to modify provisions of the PIT. These reforms would reduce PIT revenues and thereby also shift the revenue mix toward the GST/HST unless PIT rates were simultaneously raised. Any of the three methods cited earlier for consumption taxation could be employed, and here we list specific proposals that have been advanced using each method:

- **Tax-deferral method:** Increase the dollar limits and/or percentage-of-earnings limits on contributions to RPPs and RRSPs; extend the current age of 71 for mandatory annuitization or periodic withdrawals from such plans.

| Initial PIT rate ($t_0$) for GST/HST rate 0 | Spending rate ($A$) | PIT rate ($t_1$) for GST/HST rate 0.01 | Decrease in PIT rate: ($t_0 - t_1) \times 100$
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>0.20</td>
<td>1.00</td>
<td>0.1920</td>
<td>0.80</td>
</tr>
<tr>
<td>0.20</td>
<td>0.95</td>
<td>0.1924</td>
<td>0.76</td>
</tr>
<tr>
<td>0.30</td>
<td>1.00</td>
<td>0.2930</td>
<td>0.70</td>
</tr>
<tr>
<td>0.30</td>
<td>0.95</td>
<td>0.2934</td>
<td>0.66</td>
</tr>
<tr>
<td>0.30</td>
<td>0.90</td>
<td>0.2937</td>
<td>0.63</td>
</tr>
<tr>
<td>0.40</td>
<td>0.90</td>
<td>0.3946</td>
<td>0.54</td>
</tr>
<tr>
<td>0.40</td>
<td>0.80</td>
<td>0.3952</td>
<td>0.48</td>
</tr>
<tr>
<td>0.50</td>
<td>0.75</td>
<td>0.4963</td>
<td>0.37</td>
</tr>
<tr>
<td>0.50</td>
<td>0.66</td>
<td>0.4967</td>
<td>0.33</td>
</tr>
</tbody>
</table>

Notes:
- Illustrated for a 1 percentage point rate of GST/HST ($e = \text{tax-exclusive rate} = 0.01$).
- Formula: 
  \[
  t_1 = \frac{t_0 - Ae + t_0e}{1 + e(1 - A)},
  \]
  where $A = \text{spending rate out of after-PIT income (or 1 - saving rate)}$.

**Tax-prepayment method**: Increase the annual contribution limits for TFSAs from the current $5,500; allow annual or lifetime tax exemptions on limited amounts of interest, dividend, and/or capital gain incomes.\(^{120}\)

**Reduced-tax method**: Reduce the tax inclusion rate from the current 50 percent for realized capital gains, possibly making such gains entirely tax-free; allow dividend tax credits for eligible shares of Canadian corporations held in tax-deferred plans.

We focus now on the distributional implications of these kinds of reforms, which have typically been ignored or downplayed by their advocates. Table 2 displays the distribution of the types of incomes and deductions that would be most affected by the reforms; the data are for the 2010 tax year, the most recent available. Tax filers have been grouped into eight classes based on their total assessed incomes, with a separate tabulation for the combined class of $150,000+.\(^{121}\) Given income inequality in Canada, it is not surprising to observe that the ratio of percentages of total income assessed to total returns rises sharply as one moves up the income scale. The substantial progressivity of the federal PIT can be seen in the table’s last row for net taxes. However, most striking is the high concentration of financial incomes—interest, dividends, and capital gains—in the taxable incomes of the highest income classes as shown in table 2.\(^{122}\) Our measure of this concentration is to compare, for a given income class, the percentage of all income of that type with the percentage of total income assessed.\(^{123}\)

For example, the aggregated income class of $150,000+ (with just 2.2 percent of all tax filers) has 16.6 percent of total income assessed but 24.9 percent of all interest income, 51.4 percent of all taxable dividends, and 62.9 percent of all taxable capital gains. Those figures mean that capital incomes of these kinds constitute a much higher proportion for the total incomes of higher-income filers than for middle- and

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\(^{120}\) Prior to the major reforms of the late 1980s, individuals were allowed an exemption for up to $1,000 of interest and dividend income each year. Beginning in 1985, individuals could access a lifetime exemption on up to $100,000 of taxable capital gains, but this provision was phased out in the 1990s.

\(^{121}\) Note that fully 34 percent of the 24.8 million returns filed for 2010 were non-taxable. For the lowest income class (loss-$19,999), non-taxable returns constituted over 90 percent of all returns. For all tabulated income classes of $35,000 and higher, 98 percent or more of all returns were taxable. Canada Revenue Agency, *Preliminary Income Statistics—2012 Edition*, 2010 taxation year (Ottawa: CRA, 2012), table 2, “All Returns by Total Income Class.”

\(^{122}\) Note that the gross-up of eligible Canadian dividends and the 50 percent reduction for taxable capital gains do not affect the distribution of these income sources across income classes, since these proportions are independent of the tax filer’s income.

\(^{123}\) Of course, lower and middle earners hold most of their savings in tax-deferred or tax-prepaid forms, so that their interest, dividends, and capital gains in those accounts do not appear in the tax statistics; this will exaggerate the measured degree of concentration of such incomes among high-income taxpayers. However, that is irrelevant for the current analysis, which focuses on the impacts of proposals to reduce the taxation of currently taxable forms of investment income.
### TABLE 2  Distribution of Income Sources and Deduction Types, 2010 Tax Year

<table>
<thead>
<tr>
<th>Assessed income range</th>
<th>Loss- $19,999</th>
<th>$20,000- $34,999</th>
<th>$35,000- $49,999</th>
<th>$50,000- $69,999</th>
<th>$70,000- $99,999</th>
<th>$100,000- $149,999</th>
<th>$150,000- $249,999</th>
<th>$250,000+</th>
<th>All</th>
<th>$150,000+</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total returns</strong></td>
<td>37.6</td>
<td>20.0</td>
<td>15.5</td>
<td>12.2</td>
<td>8.7</td>
<td>3.8</td>
<td>1.4</td>
<td>0.8</td>
<td>100.0</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Total income assessed</strong></td>
<td>8.8</td>
<td>13.1</td>
<td>15.7</td>
<td>17.3</td>
<td>17.3</td>
<td>11.0</td>
<td>6.5</td>
<td>10.1</td>
<td>100.0</td>
<td>16.6</td>
</tr>
<tr>
<td><strong>Interest income</strong></td>
<td>10.6</td>
<td>15.8</td>
<td>14.5</td>
<td>13.4</td>
<td>11.7</td>
<td>9.0</td>
<td>7.4</td>
<td>17.5</td>
<td>100.0</td>
<td>24.9</td>
</tr>
<tr>
<td><strong>Taxable dividends</strong></td>
<td>1.2</td>
<td>3.4</td>
<td>6.8</td>
<td>10.5</td>
<td>12.8</td>
<td>13.8</td>
<td>13.6</td>
<td>37.8</td>
<td>100.0</td>
<td>51.4</td>
</tr>
<tr>
<td><strong>Taxable capital gains</strong></td>
<td>2.0</td>
<td>3.3</td>
<td>4.6</td>
<td>6.8</td>
<td>9.3</td>
<td>11.1</td>
<td>13.1</td>
<td>49.8</td>
<td>100.0</td>
<td>62.9</td>
</tr>
<tr>
<td><strong>RPP contributions</strong></td>
<td>0.6</td>
<td>4.0</td>
<td>13.3</td>
<td>24.7</td>
<td>35.2</td>
<td>15.8</td>
<td>4.6</td>
<td>1.8</td>
<td>100.0</td>
<td>6.4</td>
</tr>
<tr>
<td><strong>RRSP deductions</strong></td>
<td>1.2</td>
<td>5.4</td>
<td>11.3</td>
<td>17.5</td>
<td>22.4</td>
<td>20.5</td>
<td>12.9</td>
<td>8.9</td>
<td>100.0</td>
<td>21.8</td>
</tr>
<tr>
<td><strong>Interest expense</strong></td>
<td>4.0</td>
<td>6.9</td>
<td>9.1</td>
<td>12.0</td>
<td>14.7</td>
<td>13.7</td>
<td>12.1</td>
<td>27.5</td>
<td>100.0</td>
<td>39.6</td>
</tr>
<tr>
<td><strong>Net federal tax</strong></td>
<td>0.6</td>
<td>5.5</td>
<td>11.2</td>
<td>16.7</td>
<td>20.5</td>
<td>15.3</td>
<td>10.5</td>
<td>19.8</td>
<td>100.0</td>
<td>30.2</td>
</tr>
</tbody>
</table>

**a** Includes bond, bank, and mortgage interest; income from trusts; foreign investment income.

**b** Taxable amount of dividends from Canadian corporations; includes 44 percent gross-up for eligible dividends and 25 percent gross-up for non-eligible dividends; offset by dividend tax credits.

**c** Taxable amounts are 50 percent of capital gains realized in 2010.

**d** Includes interest expense paid on money borrowed to earn investment income; fees for management or safe custody of investments; safety deposit box charges; accounting fees for recording investment income; and investment counsel fees.

RPP = registered pension plan.
RRSP = registered retirement savings plan.

This concentration is even starker for the highest income class of $250,000+, with just 0.8 percent of all tax filers: relative to their 10.1 percent of total income assessed, they receive 17.5 percent of all interest income, 37.8 percent of all taxable dividends, and 49.8 percent of all taxable capital gains. Consequently, proposals to reduce the taxation of interest, dividends, and/or capital gains would reduce PIT progressivity unless offset by a steepening of the tax-rate schedule.

Next consider contributions to RPPs and RRSPs, which use the tax-deferral method for introducing a consumption base into the PIT. Table 2 displays a pattern for RPP contributions that rises sharply relative to total income assessed as one moves up the income scale as far as the $70,000-$99,999 class. For the three highest income classes, this ratio declines, reflecting the workplace basis of RPPs and the fact that many high earners derive their income from privately owned businesses, the professions, or self-employment. In contrast, the ratio of RRSP deductions to total income assessed continues to rise into the $150,000-$249,000 class before declining in the top-income class. This pattern reflects both the higher saving rates of high earners and the impact of the dollar limitation on RRSP contributions. Increasing the dollar ceiling would yield a disproportionately large benefit for high earners, since very few lower to upper-middle earners exhaust their current limits with the unlimited carryforwards. In 2010, a total of 21 million Canadians had an aggregate of $633 billion of accumulated unused RRSP contribution room available.¹²⁵

An item missing from table 2 is TFSA contributions, since these do not appear on tax returns that form the basis for statistics compiled by the Canada Revenue Agency. While contributing to a TFSA may appeal to individuals in many diverse situations, it is most compelling to high earners who have exhausted their contribution limits for RPPs/RRSPs and who have taxable assets that can be transferred, directly or indirectly, into a TFSA.¹²⁶ For the great majority of taxpayers, the current $5,500 annual limit on TFSA contributions is more than adequate to satisfy incremental saving needs. Analysis of proposals to double the TFSA contribution limit suggests that the additional tax benefits would go overwhelmingly to high earners and wealth holders.¹²⁷

Tax-deductible interest expense is also relevant in assessing proposals to shift the tax system further toward consumption, and table 2 shows this item rising sharply relative to income class. The classes with income above $150,000 (comprising just

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¹²⁴ Note that the bottom two tabulated income classes receive a higher percentage of all taxable interest than their share of total income, but the majority of filers in those groups are non-taxable so that their interest income in fact bears no tax.

¹²⁵ Statistics Canada, CANSIM database, v26560465, v26560468. By comparison, 25 million Canadians filed tax returns in that year; some of the difference is explained by filers with no earned income generating RRSP contribution room, such as welfare and pension beneficiaries.

¹²⁶ In-kind contributions of eligible securities to a TFSA are permitted, but capital gains on such securities are deemed to be realized and taxable at the time of transfer, while capital losses are denied any tax deduction.

¹²⁷ Kesselman, supra note 30.
2.2 percent of filers) claim 39.6 percent of all interest expense; the 0.8 percent of filers with incomes above $250,000 alone claim 27.5 percent. These tax deductions are allowed for interest incurred for financing investments held outside RRSPs/TFSAs (but not for consumption or home purchase). However, these deductions cannot be justified in Canada’s current PIT, which neither includes full capital incomes on an accrual basis (as would a pure income base) nor includes proceeds from loans (as would a pure consumption base). The current treatment is very favourable to high earners who deduct their interest expense to finance leveraged investments with returns that are taxed on a deferred and half-rate basis.

Pursuing any of the cited policy reforms to make the PIT more consumption-based would clearly reduce the system’s effective progressivity. Almost all Canadian advocates of these changes have neglected or downplayed this impact and the need for offsetting increases in the progressivity of the tax-rate schedule—particularly for the highest income brackets, which would benefit disproportionately from the reforms. Adverse distributional impacts of such reforms could be offset on average for taxpayers in any income range through changes in the PIT rate schedule. Over the course of a lifetime, for any average level of earnings, individuals with above-average savings would pay less than previously, and those with below-average savings would pay more than previously. That outcome accords with the nature and intention of a more consumption-based tax system. However, following the reform and for an extended transition period, the impacts would vary widely depending on the age or cohort of the individual and whether savings were held most in tax-deferred, tax-prepaid, or taxable forms. These variations have been described above; some individuals would enjoy windfall gains of reduced taxes, with no incremental saving incentive, while others would suffer lump-sum losses.

**Lifetime Wealth Transfer Taxes**

Reforming the direct personal tax to a fully consumption-based scheme has been proposed by various tax analysts over the years. One version is the flat tax formulated by Robert Hall and Alvin Rabushka, which would integrate personal and business taxes with a uniform tax rate, thus eliminating rate progressivity. More common have been proposals for a personal expenditure tax (PET) that would retain progressivity of the personal rate structure but apply some combination of the tax-deferred and tax-prepaid methods to all savings and capital incomes. An early prototype of the PET was designed by the Meade taxation review committee in the United Kingdom, and in 2010 the successor Mirrlees review advocated a similar scheme with

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128 Alternatively, a consumption-based tax would deny deductibility of interest expense and exclude proceeds from loans.

129 Hall and Rabushka, supra note 75.

the additional feature of annual taxation of capital returns exceeding the normal rate of return. Boadway’s support of a progressive PET for Canada follows the Meade formulation. All of these PET proposals other than the flat tax would simultaneously introduce a lifetime wealth transfer tax; this tax would be applied at progressive rates to donors’ cumulative inter vivos transfers and bequests. Such a wealth transfer tax is deemed essential by these proponents to prevent capital accumulated but not spent during a person’s lifetime from escaping tax under the PET.

Some variant of these proposals for a fully consumption-based personal tax, with appropriate rate progressivity, might be attractive if the companion tax on lifetime wealth transfers were deemed feasible, effective, and durable. We have reasons to doubt that such a wealth tax would meet these criteria, especially in the Canadian context. With the 1972 income tax reforms, the federal government withdrew from estate taxation, and the provinces abandoned such taxes in the following years. The prospect of reintroducing estate taxes has never been popular among Canadians, and the pattern around the world has been a small and declining role for taxes on transfers, bequests, and wealth (other than real property) in total revenues. Political economy can help to explain these phenomena: with high thresholds, such taxes affect relatively few individuals, offering limited revenue potential, and the wealth and status of these families facilitates political lobbying to eviscerate the tax legislation. The resulting instability of wealth transfer taxes yields inequities as well as taxpayers who are waiting for their desired change of government. High costs of administration and compliance together with extensive tax-planning opportunities further encumber such taxes, as do difficulties in taxing decedents’ real and financial assets held abroad. We feel that a more effective course is to leave some capital income taxable annually under the PIT particularly for high-income and high-wealth individuals.

131 James Mirrlees, Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011), 297-303 and 332-34. The normal return to capital is exempt from any consumption-based tax, but higher returns may reflect investor skills, inside knowledge, economic rents, or factors such as market power or political influence, and therefore should be taxable. Difficulties with the Mirrlees review’s proposed “rate-of-return allowance” include annual valuation of all affected assets held by individuals and determining the normal rate of return.

132 Boadway, supra note 31.

133 Robin Boadway, Emma Chamberlain, and Carl Emmerson, “Taxation of Wealth and Wealth Transfers,” in *Dimensions of Tax Design*, supra note 72, 737-814, outline the rationale for such a tax to accompany a progressive PET.

CONCLUSION AND DISCUSSION

Many tax economists, policy analysts, and policy commentators have advocated making Canadian taxes more consumption-based—either by shifting the tax mix to less use of the PIT and greater use of the GST/HST, or by shifting the PIT base further toward consumption. However, the rationales for these reform proposals suffer from serious deficiencies. Proponents of such policies have focused on studies that suggest large gains in economic incentives, efficiency, and growth, but these theoretical and econometric estimates are notoriously fickle and sensitive to key assumptions.135 The two most frequently cited Canadian studies have conclusions that proponents interpret in overly strong and definitive terms. Proponents also often cite findings from foreign or cross-country studies, and they ignore the fact that Canada’s PIT base is already close to consumption for the great majority of taxpayers other than those at the highest income levels.

Our review of the evidence suggests that the economic gains from the proposed reforms are likely to fall far short of the claims and may be negligible or even nonexistent. The effects of either type of reform on work incentives are likely to be minimal and could well be adverse rather than conducive to working. The impact of the proposed reforms on aggregate domestic savings are uncertain, but likely small at best, and even increased personal savings are unlikely to translate into much domestic investment, given the openness of the Canadian economy and heavy corporate reliance on internal finance. Small business might be induced to invest more, but tax preferences already accord them inefficiently favourable treatment. Moreover, the gains by top wealth holders in allocating their consumption more efficiently over time will not necessarily yield greater savings—the main channel for transmission of benefits to the rest of the economy.136 Thus, the economic case for such reforms is undermined by several weak links, since it is based on asserted behavioural responses for which the relevant evidence is at best unsettled.

At the same time, Canadian advocates of consumption-based tax reforms have too often tended to ignore or minimize the adverse distributional impacts of their proposals. They have neglected the need to steepen the progressivity of the PIT rate schedule—cutting upper-bracket rates less than lower-bracket rates—if a shift in the tax mix toward greater use of the GST/HST is to avoid regressive impacts. Limited cuts in upper-bracket PIT rates also imply that any associated efficiency gains will be correspondingly attenuated. Because the types of capital incomes subject to the PIT are highly concentrated at top incomes, the advocates have similarly neglected the need to increase upper-bracket rates if a shift of the PIT base toward consumption

135 For example, see our earlier citation of cautions by leading economic authorities on this topic, including Auerbach, supra notes 97 and 103; Kotlikoff, supra note 115; Lim Rogers, supra note 98; and Zodrow, supra notes 94 and 80.

136 Other channels for efficiency gains could include reduced inter-asset distortions, such as the bias as between home equity and business investment.
is to avoid regressive impacts. Any incentive gains anticipated for higher earners are therefore likely to be muted or entirely absent. Thus, most proponents of consumption-based tax reform appear to overstate the efficiency gains while minimizing or entirely ignoring the equity losses. Even if the efficiency gains were significant, the adverse distributional impacts would still need to be addressed.

Pursuing reforms to shift Canadian taxes toward consumption at the business rather than personal level offers a much better prospect of achieving the vaunted gains in investment, productivity, and growth. This difference follows from the cited international mobility of capital and corporations’ primary reliance on internal finance, which impair the effectiveness of PIT reforms and PIT-GST/HST tax-mix changes. Cuts in corporate tax rates and increased depreciation rates for business will raise the net return to foreign as well as domestic investors and thereby stimulate investment; these changes are also among the most economically efficient of tax reforms. Moreover, harmonizing provincial sales taxes with the GST moves the tax base from its hybrid form (with roughly 40 percent of the burden being borne by business) to a true consumption-based tax for households. Tax harmonization is found to be effective in raising business investment by reducing the cost of capital purchases, while imposing little change in distributional impacts. Sales tax harmonization is primarily a tax base reform and only to a minor extent a tax-mix shift since most of the savings for business have been passed through to consumers via lower prices.

If any economic gains from shifting Canadian taxation toward consumption are much smaller than the advocates claim—and given that these shifts have an adverse impact on distribution—what rationale does that leave for such tax reforms? As one analyst has observed, “[t]his is not to say that a consumption tax is a bad idea, but rather to say that the reform may be difficult to justify on the grounds of economic efficiency alone.” When considering expanded use of indirect taxes like the GST/HST, a clue lies in the policy experience of countries that apply VAT at much higher rates than Canada alongside heavy use of direct taxes on individuals and

137 See Dahlby, supra notes 105 and 12 and studies cited therein. See also Arnold, supra note 92, and Johansson et al., ibid.
139 Smart and Bird, supra note 117, find only a slightly regressive impact on Ontario households, while the results in Jonathan R. Kesselman, “Consumer Impacts of BC’s Harmonized Sales Tax: Tax Grab or Pass-Through?” (2011) 37:2 Canadian Public Policy 139-62, suggest possibly a slightly progressive impact on BC households.
141 Lim Rogers, supra note 98, at 45.
businesses. For example, the Nordic countries apply VAT at 25 percent, and they employ their large total revenues from all sources to fund expansive services that are highly progressive. Thus, if Canadian direct taxes are already being deployed to their economically optimal limits, increased rates of GST/HST could be justified in revenue-enhancing moves to address pressing social and societal needs; the progressive impact of the incremental spending could outweigh the regressive impact of the additional revenues.\textsuperscript{142}

\textsuperscript{142} In contrast, some Canadian proponents of a shift from the PIT to the GST/HST specifically state that the reform should be revenue-neutral (for example, Mintz, supra note 18, and Laurin and Robson, supra note 13) or even revenue-reducing (Clemens et al., supra note 10). On the revenue side alone, a tax system that is highly progressive can exert a large redistributive effect only to the extent that the overall tax level is large (Kesselman and Cheung, supra note 116, at 732). Also see Lane Kenworthy, \textit{Progress for the Poor} (Oxford: Oxford University Press, 2011), at chapter 8.
The Section 68 Reasonableness Standard After TransAlta

Robert D. McCue*

PRÉCIS

Cet article examine la jurisprudence et la pratique administrative entourant l’article 68 de la Loi de l’impôt sur le revenu, qui a donné lieu à la récente décision de la Cour d’appel fédérale dans l’arrêt TransAlta Corporation c. Canada. Une attention particulière est portée à la façon dont les tribunaux ont défini et évalué l’achalandage, et leur interprétation du caractère raisonnable au coeur de l’article 68. L’auteur conclut que TransAlta fournit jusqu’à présent l’interprétation la plus claire fondée sur des principes de l’article 68 et que la Cour d’appel fédérale a trouvé un équilibre adéquat entre les principes concurrents de prévisibilité et d’équité du point de vue du contribuable, d’une part, et le besoin de discrétion judiciaire pour freiner l’évitement fiscal inadéquat, d’autre part. La Cour y est parvenue en rejetant un critère légaliste qui aurait exigé l’exercice d’une discrétion judiciaire importante, en faveur d’un critère qui correspond à un jugement d’affaires exercé de façon raisonnable. L’auteur conclut par des suggestions quant à la façon dont les principes dans TransAlta peuvent s’appliquer aux causes futures liées à l’article 68.

ABSTRACT

This article examines the case law and administrative practice surrounding section 68 of the Income Tax Act, culminating in the recent Federal Court of Appeal decision in TransAlta Corporation v. Canada. Particular attention is paid to how courts have defined and valued goodwill, and their interpretation of the reasonableness standard at the core of section 68.

The author concludes that TransAlta provides the most articulate and principled interpretation of section 68 to date, and that the Federal Court of Appeal appropriately

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balanced the competing principles of predictability and fairness from the taxpayer’s perspective, on the one hand, and the need for judicial discretion to curb inappropriate tax avoidance, on the other. The court achieved this by rejecting a legalistic test that would have required the exercise of significant judicial discretion, in favour of a test that is consistent with reasonably exercised business judgment. The author concludes with suggestions as to how the principles in TransAlta may apply to future section 68 cases.

**KEYWORDS: ALLOCATION • CONSISTENCY • DISCRETIONARY • DISPOSITIONS • GOODWILL • VALUATION**

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*Everything in the universe goes by indirection. There are no straight lines.*

Ralph Waldo Emerson

## INTRODUCTION

In *TransAlta Corporation v. Canada*, the Federal Court of Appeal wrestled with one of the perennial issues in tax law: How broad should be the Crown’s or a court’s discretion to curb tax planning? The specific question was whether the minister was correct in using section 68 of the Income Tax Act to overturn a purchase price allocation made by arm’s-length parties. The court rejected the Crown’s attempt to...

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1 2012 FCA 20; rev’g. (in part) 2010 TCC 375.
2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.
3 By way of legislation enacted by SC 2013, c. 34, section 207, the preamble of section 68 was amended and new paragraph 68(c) was added to deal specifically with amounts that may reasonably be regarded as consideration for a restrictive covenant. The test articulated by the Federal Court of Appeal in TransAlta (discussed in the text below) should apply to interpret this new provision.
interpret section 68 so as to dramatically extend that section’s scope, as well as ministerial and judicial discretion regarding when the section should apply. The court also clarified section 68’s foundational principles. As a result, TransAlta increases the ability of taxpayers and the Crown to predict when section 68 will apply.

In this article, I will summarize the section 68 case law that preceded TransAlta and analyze the Tax Court and Federal Court of Appeal judgments in that case. I will also comment on how TransAlta may influence future case law.

The case law and administrative dicta with regard to section 68, other than the Tax Court’s decision in TransAlta, are mostly consistent with the Supreme Court of Canada’s statement in Canada Trustco Mortgage Co. v. Canada about the importance of interpreting the Act so as to promote consistency, certainty, predictability, and fairness from the perspective of taxpayers. However, as illustrated by the minister’s reassessment and the Tax Court’s judgment in TransAlta, significant uncertainty existed as to how section 68 should be interpreted.

This kind of uncertainty with regard to the law’s application is problematic for various reasons. For example, the minister tends to take more aggressive reassessing

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5 2005 SCC 54.

6 I use the words consistency, certainty, predictability, and fairness in this article as they were used by the Supreme Court in Canada Trustco, supra note 5, at paragraphs 1, 11, 12, 15, 42, 50, and 61. The court has also mentioned variants of this principle in a number of other recent tax cases, including Daishowa-Marubeni International Ltd. v. Canada, 2013 SCC 29; rev’g. Daishowa Paper Manufacturing Ltd. v. Canada, 2011 FCA 267; rev’g. Daishowa-Marubeni International Ltd. v. The Queen, 2010 TCC 317; and Fundy Settlement v. Canada, 2012 SCC 14; aff’g. St. Michael Trust Corp. v. Canada, 2010 FCA 309; aff’g. Garron Family Trust v. The Queen, 2009 TCC 450. These words articulate the taxpayers’ perspective and, in the context of Canada Trustco, are contrasted against the uncertainty necessarily caused by the general anti-avoidance rule (GAAR) as it restrains abusive tax avoidance. The importance of certainty in the interpretation of tax law has a long history. See Sullivan, supra note 4, at 530-36; Lisa Philipps, “The Supreme Court of Canada’s Tax Jurisprudence: What’s Wrong with the Rule of Law” (2000) 79:2 Canadian Bar Review 120-44. See Duff, supra note 4, “… Part 2”; Brooks, supra note 4; and Sullivan, supra note 4, at 528, for summaries of how the interpretation of tax law in Canada has evolved from strict construction.

positions when there is significant uncertainty as to how provisions of the Act should be interpreted. Many taxpayers have been reassessed pursuant to section 68 during the past decade or so on the basis of questionable valuation reports produced by the Canada Revenue Agency (CRA), such as the valuation reports used by the Crown at trial in TransAlta. And some taxpayers have settled with the minister, presumably on a basis that encouraged the similar reassessment of other taxpayers. Accordingly, the Federal Court of Appeal's approach to predictability in TransAlta is important and will be one of the lenses through which I will look at that case.

SECTION 68 CASE LAW

The relevant aspects of section 68 can be paraphrased as follows:

Where an amount can reasonably be regarded as being consideration for the disposition of a particular property of a taxpayer, that amount shall be deemed to be proceeds of disposition of the particular property.

Section 68's purpose is evident within its text, namely, to prevent unreasonable purchase price allocations. The section has been interpreted not to apply as long as the taxpayer's purchase price allocation is not found to be clearly unreasonable. The case law has used various tests to determine reasonableness.

The two main issues regarding section 68 in TransAlta were, first, how goodwill should be defined and valued, and second, how the reasonableness principle in section 68 should be applied in light of the valuation and other evidence relative to the goodwill in question.

Definition and Valuation of Goodwill

In a 1981 Canadian Tax Journal article that has been frequently cited with approval with regard to the meaning of goodwill, John Durnford shed light on the reasons for the use of different goodwill definitions in the tax case law. Two types of definitions have been used. The first was developed by the common-law courts as they grappled with the question of whether goodwill existed and how to identify it. The second evolved later within the accounting and valuation professions as a means of valuing goodwill once it had been found to exist, and is referred to as the “residual” method of defining or, more accurately, valuing goodwill. By that method, the value of goodwill is what remains after the value of the other assets of a business has been accounted for. The other assets are, generally, tangible and identifiable intangible property.

Durnford noted that in 1981, the two kinds of goodwill definition were merging. Subsequent case law continued the trend he identified. For example, in *Les Placements A & N Robitaille Inc. v. MNR*, the Tax Court cited Durnford with approval, referred to the traditional legal definition of goodwill for the purposes of determining whether goodwill existed, and then used the residual method to value goodwill. Similar results followed in *USM Canada Limited v. The Queen*, *Teleglob Canada Inc. v. The Queen*, and *Petersen v. MNR*. And *Interpretation Bulletin IT-143R3* describes goodwill in terms resembling the legal definition before adopting the residual method of valuing goodwill.

Residual valuation has also been used in a number of contexts other than section 68. The justification is pragmatic: when allocating value between assets that have been jointly acquired, the best way to value each is to first value the asset that can be most reliably valued, and then derive the value of the other asset.

**Reasonableness**

*The Queen v. Golden et al.* is the Supreme Court of Canada’s only judgment addressing the reasonableness concept in section 68, and, as the trial judge in *TransAlta* noted, reasonableness was a side issue in the case.

*Golden* concerned the allocation of consideration from the sale of a condominium project as between land and buildings. The Federal Court Trial Division applied section 68 to reallocate the taxpayer’s proceeds of disposition. The Federal Court of Appeal overturned the Trial Division. Heald JA wrote the majority’s judgment for the Court of Appeal, while Thurlow CJ concurred in the result for different reasons. The majority of the Supreme Court of Canada agreed with both Federal Court of

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9 *Les Placements*, supra note 8, at 1070-72.
10 *USM Canada*, supra note 8.
11 2000 DTC 2493, at paragraph 67 (TCC); aff’d. 2002 FCA 408.
12 88 DTC 1040, at 1045 (TCC).
15 For example, if the entire business is worth $100 million and the assets other than goodwill can be reliably valued at $80 million, the goodwill must be worth $20 million.
16 [1986] 1 SCR 209; aff’g. *Golden v. The Queen*, 80 DTC 6378 (FCTD); rev’g. 83 DTC 5138 (FCA).
17 *TransAlta*, supra note 1 (TCC), at paragraph 43.
Appeal judgments as to the reasonableness of the purchase price allocation and hence, the non-application of section 68.18

Given Golden’s continuing importance to the interpretation of section 68, I will review it with care.

The facts in Golden were that the purchaser (Nelson Skalbania, a well-known real estate developer in western Canada) initially offered $5.6 million for a condominium project and proposed to allocate the purchase price as follows: $2.6 million to land; $2.4 million to buildings; and $600,000 to miscellaneous assets. After negotiation, Skalbania acquired the project for $5.85 million and allocated $5.1 million to land and the balance of $750,000 to buildings, equipment, and improvements.19

The CRA reassessed under section 68 on the basis that the vendor-taxpayer’s price allocation was unreasonable. At trial, there was no evidence of specific negotiation with respect to the allocation of the purchase price. And the valuation evidence indicated that the purchase price allocation agreed upon by the parties was dramatically inconsistent with the fair market value.

The Federal Court Trial Division in Golden made two findings that are of particular importance:20

1. Only the vendor’s perspective was relevant to the determination of reasonableness for the purposes of section 68; hence, the fact that the amount allocated to the land in question was reasonable from the purchaser’s perspective was irrelevant.
2. The absence of “hard bargaining” with regard to the purchase price allocation meant that the taxpayer had not made out a prima facie case for a reasonable purchase price allocation; hence, the court was required to determine the reasonable allocation.

The Federal Court of Appeal disagreed. Heald JA for the majority held21 that

1. both the purchaser’s and the vendor’s perspectives should be considered in determining reasonableness for the purposes of section 68;
2. the trial judge had found that the purchase price allocation was reasonable from the purchaser’s perspective;
3. great weight should be given to an arm’s-length agreement as to allocation; and
4. accordingly, section 68 did not apply in spite of the valuation evidence that the trial judge had accepted as the best indicator of the land’s value for the purposes of section 68.

18 Golden, supra note 16 (SCC), at paragraph 13.
19 Golden, supra note 16 (SCC).
20 Golden, supra note 16 (FCTD), at 6380.
21 Golden, supra note 16 (FCA), at paragraphs 6 and 14-15.
Thurlow CJ agreed with the result and the majority’s reasons, and added that, among other things, an owner of assets may dispose of them as he sees fit and may “realize on the full potential of an asset of one kind even if as a result the greatest potential of a related asset cannot be realized in the transaction.” Thurlow CJ also noted that the purchase price allocation had a reciprocal effect, meaning that the vendor’s gain, by avoiding recapture, would cause the purchaser to have less future depreciation. The importance of predictability is clearly discernible in the chief justice’s reasons.

As indicated above, the Supreme Court of Canada adopted the reasons of both Heald JA and Thurlow CJ with respect to the allocation of the purchase price and, accordingly, must be taken to have endorsed the broad deference to arm’s-length price allocations stipulated by the chief justice. Regrettably, this was not picked up clearly in subsequent cases until the Federal Court of Appeal’s judgment in TransAlta.

The Trial Division’s judgment in Golden was consistent with prior case law with regard to the importance of specific bargaining to the reasonableness of purchase price allocations and the shift of onus to the Crown that would occur once the taxpayer had made out a prima facie case that hard or genuine bargaining had occurred. For example, in each of The Queen v. Waldorf Hotel (1958) Ltd. et al. (often referred to as “Shok”), Erawan House v. MNR, and Robbins v. MNR, section 68 was applied to reallocate purchase prices on the basis that, while arm’s-length parties had agreed to the allocation, they had not specifically bargained in that regard. This prevented the taxpayers in these cases from taking advantage of the presumption in their favour that arm’s-length bargaining leads to reasonable purchase price allocations, and as a result, valuation evidence trumped the fact that the price allocation had been agreed upon by arm’s-length parties.

It is, accordingly, of particular importance to note that neither the Federal Court of Appeal nor the Supreme Court of Canada in Golden mentioned specific bargaining with regard to the purchase price allocation as a factor meriting particular weight. Instead, they resolved the case in favour of the taxpayer on the basis of facts that were much less favourable to the taxpayer than those in prior cases in which section 68 had applied. In that context, the Federal Court of Appeal’s ruling that an arm’s-length relationship alone is an “important consideration” meriting “considerable weight” is crucial.

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22 Ibid., at 5143.
23 Ibid.
24 75 DTC 5109 (FCTD).
25 76 DTC 1049 (TRB).
26 78 DTC 1669 (TRB).
27 Golden, supra note 16 (FCA), at 5142 and 5144.
It is also important to note that the Federal Court of Appeal’s ruling was based, in part, on the trial judge’s finding of fact that the purchase price allocation was reasonable from Skalbania’s perspective. On that point, the trial judge held:

It is not for me to speculate why Skalbania did not find it necessary to insist on a higher allocation to depreciable assets; he bought the land for $5,100,000 and he paid for it and I have no reason to suspect, much less infer, that it was worth anything less to him.

I accept that the value of the Bel Air land to Skalbania in March, 1973, was $5,100,000. That is what Skalbania, a knowledgeable purchaser, dealing at arm’s length, agreed to pay for it on March 14, 1973.

This aspect of the judgment appears to be based on Skalbania’s well-known sophistication as a real estate developer and his arm’s-length relationship to the vendor, rather than on anything about the price allocation or how it was determined per se.

At a minimum, in light of the facts and the Supreme Court’s reasoning in Golden, as well as later cases that have applied that case, it is safe to conclude that the pre-Golden case law read section 68 too broadly. In particular, those cases overemphasized valuation evidence and specific bargaining relative to the goodwill allocation and put inadequate emphasis on arm’s-length agreement and other indicia of reasonableness, such as the sophistication of the parties. The Supreme Court’s judgment in Golden reduced judicial discretion to overturn arm’s-length purchase price allocations under section 68.

Some of the most useful post-Golden section 68 cases were decided in favour of the Crown and define the kinds of unreasonable behaviour that must be found in an arm’s-length purchase price allocation case for section 68 to apply. Petersen,30 H. Baur Investments Limited v. MNR,31 and Staltari v. The Queen32 are examples.

Petersen stands for the proposition that, in arm’s-length purchase price allocation cases that do not involve sham or subterfuge, the court must determine that an allocation of purchase price to goodwill is “clearly unreasonable” in order for section 68 to apply.33 The facts in Petersen illustrate a clearly unreasonable case without defining the term. That is,

- there was no specific bargaining regarding the purchase price allocation to goodwill;
- there was a history of consistent losses;

28 Ibid., at 5142-43.
29 Golden, supra note 16 (FCTD), at 6380 (emphasis added).
30 Petersen, supra note 12.
31 88 DTC 1024 (TCC); aff’d. 90 DTC 6371 (FCTD).
32 95 DTC 506 (TCC).
33 Petersen, supra note 12, at 1045-46. This language echoes the Canada Trustco requirement that abuse for GAAR purposes be clear (supra note 5).
there was no prospect of future income;

- significant repairs were required; and
- there were problems with the government licence related to the business.

Other facts supported the Tax Court's finding that the allocation of any value to goodwill in that case was clearly unreasonable.

Both the Supreme Court's judgment in *Golden* and the Tax Court's decision in *Petersen* were considered by the Tax Court in *H. Baur*, where the vendor filed his tax return on the basis of a purchase price allocation that differed from what he had agreed upon in writing with the purchaser. The Tax Court was not persuaded by the appraisal evidence that was put forward to support the inconsistent price allocation, and, on appeal, the Federal Court Trial Division agreed.34 This case demonstrates, among other things, the importance of arm's-length agreements with regard to the determination of reasonableness for the purposes of section 68 and the limitations of appraisal evidence. *H. Baur* is consistent with the Supreme Court's decision in *Golden* on both of these points.

It is fair to characterize *Petersen* and *H. Baur* as examples of clearly unreasonable purchase price allocations. Accordingly, section 68 should apply in those cases.

*Golden* and *Petersen* were again considered by the Tax Court in *Staltari*. There, the taxpayer had received $185,000 from his former employer (“RRL”) in settlement of an action for wrongful dismissal. The parties allocated $100,000 to proceeds of disposition of the taxpayer’s 50 shares in a related company (“RCPC”). An RCPC shareholders’ agreement provided that in the event of cessation of the taxpayer’s employment, RCPC or RRL had the option to purchase the shares for fair market value as determined by a specified appraisal process. The accounting firm Peat Marwick had valued the taxpayer’s RCPC shares at $12,375 in accordance with that appraisal process. At least one other arm’s-length transaction had occurred on this basis at a similar value.

The minister disagreed with the allocation of $100,000 to the RCPC shares and reassessed the taxpayer under section 68 to reallocate the settlement proceeds on the basis that $15,000 was the amount reasonably allocated to those shares.

The Tax Court found that the settlement was “at arm’s length and was not a sham or subterfuge,”35 that each of the parties was aware of the tax consequences entailed by the settlement, and that the reason for settlement was the desire to avoid expensive litigation. The court observed that in such situations, transaction dynamics should not be expected to push parties toward a reasonable allocation for section 68 purposes. The court cited *Petersen* and, in particular, quoted Rip J’s ruling that where an agreement, absent sham or subterfuge, stipulates an amount that is “clearly unreasonable,” it is open to the court to apply section 68.36

34 H. Baur, supra note 31 (TCC), at paragraphs 6 and 13; (FCTD), at paragraph 5.
35 Staltari, supra note 32, at 509.
36 Ibid., at 509, quoting from Petersen, supra note 12, at 1045-46.
The court then held that the taxpayer did not satisfy the onus on him to establish that the minister’s reallocation was “unrealistic.” The taxpayer’s allocation was found to be unreasonable in the circumstances, and so the Crown prevailed. The unreasonableness of the price allocation in this case was not as clear as it was in Petersen and H. Baur.

Petersen and Staltari each describe the generally applicable legal onus on taxpayers to prove that the minister’s assumptions are incorrect. In addition to this legal onus, tax cases involve important practical or evidentiary onuses, as do all other types of litigation. The practical onus depends upon the nature of the substantive test in question and the quality of the evidence led by each party.

For example, a purchase price allocation must be clearly unreasonable in an arm’s-length case in order for section 68 to apply. As a result, the practical or evidentiary onus may shift as follows. The taxpayer will be required to establish that the transaction in question is a typical arm’s-length transaction that did not involve sham or subterfuge. Then, the taxpayer will provide all of the evidence available with respect to reasonableness, including

- the degree of the taxpayer’s and other parties’ expertise and sophistication with regard to the matters in question;
- the extent of specific purchase price allocation negotiations and how much the parties had at stake in that regard;
- the extent to which the purchase price allocation was consistent with industry, audit, or valuation principles and practices; and
- any expert or other valuation evidence that would support the purchase price allocation.

The strength of that evidence will determine the nature of the practical onus that the Crown bears to establish that the purchase price allocation is clearly unreasonable. Accordingly, when the Tax Court in Petersen and Staltari held that the taxpayer had failed to discharge his burden, it was also indicating that, in light of the evidence provided by the taxpayers, the Crown had successfully discharged its practical onus to establish that the purchase price allocation was clearly unreasonable.

Interpretation Bulletin IT-220R2, dated May 25, 1990, provides a reasonable summary of the main facets of the case law, as follows:

Even where a value is specified in an agreement for each class or kind of property or service and the total consideration for the whole sale is reasonable, a re-allocation of the consideration between the various kinds or classes of property or services, may, nevertheless, be made by the Department if some or all of the values specified are considered

37 Staltari, supra note 32, at 509.
The section 68 reasonableness standard after TransAlta

unreasonable. Where, however, the parties to the agreement are dealing at arm’s length, the agreement is prima facie evidence of the reasonableness of the allocation specified therein. The taxpayer’s allocation is further supported where there is evidence of hard bargaining between the parties involved in arriving at that allocation.39

This administrative dictum is consistent with, if not as fine-grained as, the case law described above.

With that background in mind, I will proceed to a discussion of TransAlta itself, first at the Tax Court and then at the Federal Court of Appeal.

**TransAlta Tax Court Judgment—Judicial Discretion Trumps Predictability**

The facts in TransAlta were straightforward. In 2002, TransAlta sold its electricity transmission business (“the transmission business”) to AltaLink, a privately owned limited partnership that was formed by a consortium for the purpose of acquiring that business.

TransAlta and AltaLink dealt with each other at arm’s length and negotiated the purchase and sale agreement with respect to the transmission business in typical fashion. This negotiation included specific attention to the purchase price allocation clause, which applied approximately $190 million of the $818 million purchase price to goodwill. The final allocation to goodwill was approximately $36 million less than TransAlta’s starting position, while the amount allocated to depreciable property was correspondingly increased during negotiations. This purchase price allocation was consistent with (1) industry practice, as indicated by values determined by the relevant regulatory authority; (2) a wide variety of comparable transactions; (3) valuation evidence on which the auditors who approved AltaLink’s financial statements must have relied; and (4) an expert valuation report prepared for TransAlta.

The minister reassessed on the basis that there could be no goodwill in this particular regulated industry, and attempted to use section 68 to reallocate to depreciable property all of the $190 million the parties had allocated to goodwill. This reassessment converted a large gain from a disposition of eligible capital property40 into fully taxable recaptured depreciation. TransAlta appealed to the Tax Court.

TransAlta’s position was that the fair market value of tangible assets in this industry approximates the net book value of those assets for regulatory purposes, and supported this conclusion using valuation data provided by the industry regulator, valuators, and audit firms. In response, the Crown argued at trial and before the

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39 IT-220R2, supra note 14, at paragraph 5. I note that while this administrative position acknowledges the onus shift required by Golden and Petersen on the basis of arm’s-length parties, it does not specify that the minister establish that the purchase price allocation is clearly unreasonable. By the time this interpretation bulletin was published, Petersen had been on the books for almost two-and-a-half years.

40 Taxable on more or less the same basis as a capital gain.
Federal Court of Appeal that this evidence should be ignored because it resulted from a widespread desire to reduce taxes paid when regulated businesses are sold for more than book value. The Crown’s sole support for this position was found in an expert report that did not value the assets in question, but rather attempted to establish a theoretical basis for the proposition that there was either no or only minimal goodwill in this kind of case.

The Crown also asserted the right to exercise a broad discretion to substitute the minister’s judgment as to what was reasonable for that of arm’s-length taxpayers, even though the purchase price allocation agreed to by those taxpayers was consistent with the broad range of regulatory, industry, and other third-party valuation evidence noted above.

The Tax Court held that 74 percent of TransAlta’s allocation of the purchase price to goodwill should stand, and that 26 percent should have been allocated to depreciable property. The court also attempted to systematize the law related to section 68 and, in the course of doing so, raised novel interpretive issues. At the core of the court’s reasons were the issues of how goodwill should be defined and valued, and how the reasonableness test should be applied for section 68 purposes.

**Definition and Valuation of Goodwill**

At the root of the goodwill definition issue was the Tax Court’s conclusion that the residual method of valuing goodwill was not a definition of goodwill.41 The confusing nature of academic and judicial commentary respecting the residual method of valuing goodwill is likely responsible for this. However, the court’s adoption of this approach may have caused it to avoid grappling with third-party evidence with regard to value on which this aspect of the case should have been decided. Instead, the court focused on the legal definition of goodwill (discussed below) and how goodwill in this case must be characterized in light of that definition. This, ironically, led the court to substitute its own ad hoc valuation for the only expert valuation evidence before it. That evidence agreed with the extensively tested valuation data produced by the regulatory system to which the transmission business was subject, as well as the valuation that could be inferred from the audited financial statements of AltaLink and its partners. For a number of years, the value that TransAlta and AltaLink had allocated to goodwill in those statements had not been questioned.

The approach adopted by the Tax Court indicated that future courts should exercise broad judicial discretion as a result of the many ways in which goodwill could be characterized in this kind of case.

At trial, the Crown’s expert took the position that the tangible assets in question were the only source of revenue within the regulatory system in question, and hence all of the transmission business’s revenue and value was attributed to those assets. The Tax Court rejected this position, largely on the basis that TransAlta’s expert and other evidence indicated that the transmission business included a variety of

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41 *TransAlta*, supra note 1 (TCC), at paragraph 34.
actual and potential revenue sources that were unrelated to the regulated, tangible assets. These included various non-regulated business opportunities that AltaLink intended to pursue within the transmission business. AltaLink had attributes that suited it to capitalize on certain of those opportunities, and it was reasonable to expect that it would pay for those opportunities. The court found that this aspect of the transmission business was goodwill to which a significant portion of the purchase price was rightly allocated.

The Tax Court adopted the classic legal definition of goodwill that evolved to deal with questions of whether goodwill existed instead of what it is worth. That baroque formulation was articulated over 100 years ago by the House of Lords and contains three important elements:

1. goodwill is hard to define;
2. goodwill has a source within the business in question; and
3. goodwill is a whole and judges should not attempt to break it into its component parts.

The Tax Court then found that two elements that TransAlta and its expert had described as contributing to the value of the goodwill that it had sold were not sufficiently tied to sources within the transmission business. These were the opportunity for AltaLink (1) to use more leverage than TransAlta had used and (2) to receive a reimbursement for taxes that would probably exceed the taxes that AltaLink’s partners would actually pay (factors referred to, respectively, as “leverage” and “the tax allowance”). Each of these factors would increase AltaLink’s net after-tax return. The court described these factors as “reasons” having to do with attributes of AltaLink that motivated AltaLink to pay more for the tangible assets, as opposed to attributes of the transmission business itself, including goodwill. Therefore, the court concluded, value attributable to these “reasons” could not reasonably be allocated to goodwill.

The court’s ruling on this point emphasized the House of Lords’ comment that the goodwill of a business must emanate from a particular source within the business, while ignoring its counsel that goodwill cannot be parsed into its component parts.

On the basis of unstated valuation principles, the Tax Court concluded that the leverage and tax allowance elements had a combined value of between $50 million and $75 million, and applied section 68 to deduct the lower of those amounts from the portion of the purchase price that TransAlta was permitted to allocate to goodwill.

The Tax Court’s reasoning in this case raises a number of theoretical and practical difficulties. For example, the court did not explicitly reject TransAlta’s expert valuation of the tangible assets. However, by virtue of its use of the goodwill definition

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43 TransAlta, supra note 1 (TCC), at paragraphs 59-62.
44 Ibid., at paragraphs 72-73.
described above, the court substituted its own unstated valuation theory with regard to tangible assets for that put forward by TransAlta’s expert. So, instead of deciding section 68 cases on the basis of the most reliable valuation principles and evidence available, the Tax Court judgment requires that section 68 cases be decided on the basis of an archaic, complex definition of goodwill, followed by a valuation based on unstated principles.

In addition, there was no evidence before the court as to AltaLink’s reasons for paying the purchase price. It would be rare for a vendor to have access to this type of information, given its strategic importance to the purchaser. Hence, the Tax Court’s approach was likely to require a speculative goodwill valuation. And, unfortunately, once goodwill has been valued, the remainder of the business is valued by inference.

**Reasonableness**

The Tax Court noted that section 68 uses a reasonableness test, and it laid out rules as to how reasonableness should be assessed in various circumstances to which section 68 might apply.\(^45\) The pre-\textit{Golden} case law generally accepts, as reasonable, price allocations that were specifically negotiated by arm’s-length parties, and, as noted above, it is easy to see the unreasonableness of the allocations in the few arm’s-length cases in which section 68 has been applied, such as \textit{Petersen}. Furthermore, in \textit{Golden}, the Supreme Court of Canada reduced judicial discretion to apply section 68 in arm’s-length cases. The Tax Court distinguished the Supreme Court’s decision in \textit{Golden} on various bases.\(^46\) With respect, the Tax Court’s judgment is probably not reconcilable with that decision.

The Tax Court was, however, correct in noting that in \textit{Golden}, the Supreme Court did not systematically interpret section 68, and that this needed to be done. In its attempt, the Tax Court articulated the arm’s-length bargaining test to include new requirements, such as relative equality of bargaining power and the financial importance of the purchase price allocation relative to the deal as a whole. In addition, while pointing to industry practice as an important factor, the court did not put much weight on it, despite the fact that in this case the evidence indicated extensive industry valuation practices that supported the parties’ agreed-upon allocation.\(^47\) Likewise, the behaviour of third parties (such as the transmission business’s regulator and AltaLink’s auditor), which had different and important stakes in the determination of the existence of goodwill and its value, did not seem to bear weight in the Tax Court’s reasoning.

In short, whereas the pre-\textit{Golden} case law appears to generally exempt arm’s-length taxpayers from the application of section 68 in cases where they bargained in the usual way with regard to purchase price allocation, and \textit{Golden} may have

\(^{45}\) Ibid., at paragraph 47.

\(^{46}\) Ibid., at paragraph 43.

\(^{47}\) Ibid., at paragraphs 64-65.
extended the scope of this exemption from section 68, the Tax Court in *TransAlta* limited the exemption to cases in which a virtually unheard-of kind of purchase price bargaining occurred. This means that the Tax Court significantly watered down what had been understood by taxpayers and treated by the courts as an arm’s-length safe harbour from the application of section 68. The Tax Court’s reasons therefore dramatically increased the opportunity for judicial discretion with regard to section 68, and accordingly augured against predictability.

Having found that the arm’s-length bargaining in this case did not rule out the application of section 68, the court went on to decide how that section should be applied. The Tax Court held that it must determine the reasonable range for the purchase price allocated to a particular item of property, and where there is an agreed allocation between arm’s-length parties within the reasonable range, that allocation will stand. Otherwise, the amount within the range closest to the parties’ allocation will be the reallocated amount for the purposes of section 68.48 According to the court, this deference to the parties’ agreed allocation puts the kind of weight on it required by *Golden* and prior case law.49 Since the court reserved for itself a wide discretion to establish the range, this deference was of little practical importance.

**TRANSLATA FEDERAL COURT OF APPEAL**
**JUDGMENT—PREDICTABILITY PREVAILS**

The Federal Court of Appeal disagreed with the Tax Court across the board.

**Definition and Valuation of Goodwill**

With regard to the goodwill definition issue, the Court of Appeal noted50 that

- both experts in this matter accepted the residual method of valuing goodwill for the purposes of applying section 68;
- the residual method had been applied in a number of section 68 cases; and
- nonetheless, the Tax Court judge rejected this method in favour of a goodwill definition that had been formulated over 100 years ago by the UK House of Lords in circumstances that differ significantly from today’s.

The Court of Appeal then provided a detailed explanation of the way in which the regulatory system in question was designed to equate the fair market value of tangible assets with their net book value for regulatory purposes, and the court accepted that a purchase price allocation that is consistent with this kind of industry practice is reasonable for the purposes of section 68. The court also accepted the expert valuation evidence provided by TransAlta, which reached the same conclusion,

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48 Ibid., at paragraph 68.
49 Ibid., at paragraphs 43-47 and 55.
50 *TransAlta*, supra note 1 (FCA), at paragraphs 68-71.
while rejecting the evidence provided by the Crown to the effect that no goodwill existed in this case.\textsuperscript{51}

The court then outlined the deficiencies of the goodwill definition adopted by the Tax Court, and held that the residual method of valuing goodwill should be used for the purposes of applying section 68.\textsuperscript{52} This led the Court of Appeal to conclude that the Tax Court judge should not have required a reduction of $50 million in the amount that TransAlta had allocated to goodwill.\textsuperscript{53} Four points are particularly noteworthy.

First, the Court of Appeal held that goodwill has three characteristics:

\begin{itemize}
  \item[(a)] goodwill must be an unidentified intangible as opposed to a tangible asset or an identified intangible such as a brand name, a patent or a franchise;
  \item[(b)] it must arise from the expectation of future earnings, returns or other benefits in excess of what would be expected in a comparable business;
  \item[(c)] it must be inseparable from the business to which it belongs and cannot normally be sold apart from the sale of the business as a going concern.\textsuperscript{54}
\end{itemize}

Second, the court rejected the Tax Court’s distinction between goodwill and “reasons why a purchaser would pay more for tangible assets,” holding that the trial judge misunderstood the decision in \textit{The Queen v. Jessiman Brothers Cartage Ltd.}\textsuperscript{55} on which he had relied for his finding on this point.\textsuperscript{56}

Third, the court held that the potential for leverage was an intangible asset, which, if prudently used, could potentially lead to additional income. Accordingly, it was part of TransAlta’s goodwill.\textsuperscript{57}

Fourth, the tax allowance was determined by the Court of Appeal not to be part of TransAlta’s goodwill or tangible assets on the basis that the benefit of the use of the tax allowance by a non-taxable partner of AltaLink could not be viewed as an asset of TransAlta.\textsuperscript{58} With respect, this conclusion is questionable since the potential for the tax allowance is latent in the transmission business as a result of the regulatory system to which the business is subject, in much the same way as that business offers the potential for leverage. That being said, the court’s finding on this point is useful in that it demonstrates the reasonableness test’s flexibility. That is, the court provided a number of reasons on the basis of which any value attributable to the tax allowance should not result in the application of section 68, including the following:\textsuperscript{59}

\begin{itemize}
  \item \textsuperscript{51} Ibid., at paragraphs 34-50 and 82-83.
  \item \textsuperscript{52} Ibid., at paragraphs 51-58 and 69-71.
  \item \textsuperscript{53} Ibid., at paragraph 65.
  \item \textsuperscript{54} Ibid., at paragraph 54.
  \item \textsuperscript{55} 78 DTC 6205 (FCTD).
  \item \textsuperscript{56} \textit{TransAlta}, supra note 1 (FCA), at paragraph 57.
  \item \textsuperscript{57} Ibid., at paragraph 62.
  \item \textsuperscript{58} Ibid., at paragraph 64.
  \item \textsuperscript{59} Ibid., at paragraphs 64 and 67-69.
\end{itemize}
1. The reasonableness test described below would, in any event, justify the parties’ purchase price allocation.
2. It is improper to attempt to break down goodwill into its parts.
3. The use of the residual approach to valuing goodwill resolved this issue in TransAlta’s favour because

[the fact that some intangible elements that do not constitute “goodwill” in the legal sense may be captured through [the application of the residual valuation method]—such as the potential tax allowance benefit—does not mean that the valuation method is wrong or improper. The method simply reflects the fact that these types of intangibles should be treated as goodwill for all practical purposes—including accounting and taxation purposes—even though they may not squarely fall under the legal concept of goodwill.\(^{60}\)

This reasoning illustrates the way in which the reasonableness test and the use of the residual approach to valuing goodwill should be expected to limit section 68’s scope and resolve in the taxpayer’s favour cases that may appear to have the potential to be subject to section 68.

**Reasonableness**

The Court of Appeal’s analysis of the reasonableness test is the heart of the judgment. The court rejected the test formulated by the Tax Court and provided a new test for section 68 purposes, based on the reasonableness test set out by the Exchequer Court in *Gabco v. MNR*.\(^{61}\)

According to the *Gabco* test, the minister or court should not substitute its opinion for that of the taxpayer in determining what is reasonable. Instead, the amount in question will be considered reasonable unless “no reasonable businessman would have contracted to pay such an amount having only the business considerations of the appellant in mind.”\(^{62}\) After quoting the above passage from *Gabco* and referencing *Petro-Canada v. Canada*, in which the Federal Court of Appeal adopted the *Gabco* test for the purposes of section 67,\(^{63}\) the court stated the reasonableness test for the purposes of section 68 as follows:

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60 Ibid., at paragraph 70. There is substantial commentary that supports this use for taxation purposes of legal constructs developed outside the tax system; see, for example, Lara Friedlander, “What Has Tort Law Got To Do with It? Distinguishing Between Employees and Independent Contractors in the Federal Income Tax, Employment Insurance, and Canada Pension Plan Contexts” (2003) 51:4 Canadian Tax Journal 1467-1519.

61 68 DTC 5210 (Ex. Ct.).

62 Ibid., at 5216, cited in TransAlta, supra note 1 (FCA), at paragraph 73 (emphasis added).

63 2004 FCA 158, at paragraphs 62 and 64. Section 67 is a general limitation in the Act providing that “[i]n computing income, no deduction shall be made in respect of an outlay or expense . . . except to the extent that the outlay or expense was reasonable in the circumstances.”
The concept of reasonableness under section 68 of the Act is similar to that used for the purpose of section 67 of the Act. Consequently, for the purpose of section 68 of the Act, I conclude that an amount can reasonably be regarded as being the consideration for the disposition of a particular property if a reasonable business person, with business considerations in mind, would have allocated that amount to that particular property.64

It is important to note that the Court of Appeal

- did not simply say that Gabco applied for section 68 purposes, but rather said that the reasonableness concepts in sections 67 and 68 are “similar”;
- did not use the same language as the Exchequer Court used in Gabco to articulate the test; and
- did not expressly indicate that it intended to change the Gabco test.

The question, accordingly, is whether the Court of Appeal has established different tests for sections 67 and 68, and if so, what the differences are?

**Comparison with the Decision in GlaxoSmithKline**

First, it is noteworthy that the court did not refer to the recent transfer-pricing decision in Canada v. GlaxoSmithKline,65 in which the Federal Court of Appeal applied Gabco with respect to subsection 69(2).66 Layden-Stevenson JA was a member of the Court of Appeal panel in both GlaxoSmithKline and TransAlta, and she concurred in the unanimous judgment in each case.

The purposes of section 68, combined with the facts and the Supreme Court of Canada’s reasons in Golden, justify broad deference to taxpayers’ decision making with regard to purchase price allocations. This is consistent with a literal reading of the Gabco passage referenced by the Court of Appeal in TransAlta and is at least not

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64 TransAlta, supra note 1 (FCA), at paragraph 75 (emphasis added).
65 2012 SCC 52; aff’g. GlaxoSmithKline Inc. v. Canada, 2010 FCA 201; rev’g. GlaxoSmithKline Inc. v. The Queen, 2008 TCC 324. GlaxoSmithKline was a transfer-pricing case in which both the Federal Court of Appeal and the Supreme Court of Canada held that the process required to determine profit for transfer-pricing purposes must be realistic, instead of being determined on the basis of legal principles that would be counterintuitive to most business people. The Supreme Court also held that as long as the transfer price selected by the taxpayer was within a “reasonable range,” it should not be adjusted by subsection 69(2). The court’s deference to business principles and the judgment of taxpayers enhances predictability in this area of the law.
66 GlaxoSmithKline, supra note 65 (FCA), at paragraphs 69-75. Subsection 69(2) was the predecessor to the transfer-pricing provisions now found in section 247. Subsection 69(2) formerly provided, “Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm’s length as price . . . for or for the use or reproduction of any property . . . or for other services, an amount greater than the amount . . . that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length, the reasonable amount shall, for the purpose of computing the taxpayer’s income under this Part, be deemed to have been the amount that was paid or is payable therefor.”
inconsistent with the use of the *Gabco* test in *Petro-Canada*, which the Federal Court of Appeal also referenced with approval in *TransAlta*.

Arguably, the reasonableness test in *GlaxoSmithKline* is less deferential to the taxpayer. This is consistent with the different purposes of subsection 69(2), which was at issue in that case. Accordingly, the absence of a reference to *GlaxoSmithKline* in *TransAlta* may be an example of a contextual or purposive interpretation that supports the taxpayer-friendly interpretation of the reasonableness test for section 68 purposes required by a near-literal reading of the *Gabco* test.

**“Business Considerations in Mind”**

The reasonableness test set out by the Federal Court of Appeal in *TransAlta* dropped the word “only” preceding “business considerations” in the *Gabco* test quoted above. “Only” is a strong word. For example, if “only” business considerations must have been in mind, could the fact that a taxpayer considered the income tax consequences of the purchase price allocation exclude her from the protection provided by the *Gabco* test? The answer is unclear. The Court of Appeal may have excluded the word “only” in order to avoid this kind of confusion.

The purpose of section 68 is to prevent tax avoidance beyond an acceptable point. That is, tax planning is permitted by the case law interpreting the Act, subject to specific provisions such as GAAR and section 68. It is accordingly reasonable to infer that by dropping the word “only,” the Court of Appeal intended to permit an element of non-business influence (including tax planning) in the allocation of purchase prices before section 68 would apply.

In determining how far a taxpayer should be able to go with tax planning or other non-business considerations before section 68 will apply, it is particularly important to note that the section does not use any purpose-oriented language, such as the “principal reason” language found in subsection 103(1). The absence of this language suggests that tax-planning purposes are irrelevant to the section, except to the extent that they enter into the “reasonableness” equation. This is also consistent with the relatively weak phrase “business considerations in mind” used by the Federal Court of Appeal to formulate the section 68 test.

For example, if non-business considerations (including tax planning) are the dominant purpose or reason for the purchase price allocation, it will in most cases still be possible to say that the allocation was made with business considerations “in mind.” At what point do those business considerations become so weak that they are no longer “in mind”?

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67 See, for example, *Canada Trustco*, supra note 5, at paragraphs 11 and 12; and *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, at paragraph 123; aff’d 2009 FCA 163; aff’d 2007 TCC 481.

68 Subsection 103(1) provides the minister with discretion to adjust the basis of a partnership’s allocation of income or loss where the “principal reason” for the allocation may reasonably be considered to be the reduction or postponement of tax that would otherwise be payable under the Act.
This indicates a low hurdle for taxpayers who wish to establish that section 68 does not apply to their purchase price allocations, and is consistent with the Gabco test. Again, cases such as Petersen are useful touchstones when thinking about the kind of case to which section 68 should apply.

Positive Versus Negative Phraseology

The Court of Appeal chose to frame the section 68 reasonableness test using positive instead of negative language.

As noted above, in Gabco, the Exchequer Court held that unreasonableness would be found only where “no reasonable businessman” would have contracted to pay the amount in question. Grammatical logic indicates that if a single reasonable business person would have contracted to pay the amount in question, then that amount would be reasonable. Since the Court of Appeal in TransAlta specified “a reasonable business person” instead of “any single reasonable business person” (or something similar), we must ask whether the court intended this language to differentiate the test in TransAlta from that in Gabco.

Another way to phrase the question is to ask whether the Court of Appeal’s reference to “a reasonable business person” was to any one of the possibly idiosyncratic, but still reasonable, business persons on the fringe of the population, or an average reasonable person, from nearer the centre, who represents the classic, objective reasonable person who appears in other parts of the common law. This is important because the single reasonable person test is much easier for taxpayers to meet than the average reasonable person test.

Nothing in TransAlta suggests that the Court of Appeal meant to materially change this aspect of the Gabco test for section 68 purposes; hence, if a single reasonable business person can be found or reasonably imagined to exist who would have allocated the purchase price as did the taxpayer in question, then section 68 should not apply. The following supports this view:

69 Arland and Arland v. Taylor, [1955] OR 131, at 142 (CA): “[The reasonable person is] a mythical creature of the law whose conduct is the standard by which the Courts measure the conduct of all other persons and find it to be proper or improper in particular circumstances as they may exist from time to time. He is not an extraordinary or unusual creature; he is not superhuman; he is not required to display the highest skill of which anyone is capable; he is not a genius who can perform uncommon feats, nor is he possessed of unusual powers of foresight. He is a person of normal intelligence who makes prudence a guide to his conduct. He does nothing that a prudent man would not do and does not omit to do anything a prudent man would do. He acts in accord with general and approved practice. His conduct is guided by considerations which ordinarily regulate the conduct of human affairs. His conduct is the standard ‘adopted in the community by persons of ordinary intelligence and prudence.’” (Partially quoting from Blyth v. Birmingham Waterworks Co. (1856), 11 Exch. 781.) The foregoing passage from Arland was partially quoted by Major J in Stewart v. Pettie, [1995] 1 SCR 131, at paragraph 50.
The phrase “a reasonable business person” can describe any single reasonable business person, including those at the fringes whose behaviour in any particular case may have little in common with the average person. More specific language is required to identify a particular type of reasonable business person, such as the average reasonable business person.

Section 68 is written in the affirmative, and accordingly does not easily accommodate the negative phraseology used in Gabco. The Court of Appeal may have chosen positive language that can be read into section 68 so as to achieve the same result as the Gabco test. For example, if the term “any reasonable business person” had been substituted for “a reasonable business person” in this formulation of the Gabco test relative to section 68, this choice of wording could be taken to mean that “all reasonable business persons” would have been required to agree with the allocation in order for section 68 not to apply. This would move the test far from the intent of Gabco, Petro-Canada, Golden, and Petersen, each of which was cited with approval by the Court of Appeal.

The Court of Appeal’s approval of Petersen is particularly noteworthy. That case interpreted Golden as requiring that a purchase price allocation be “clearly unreasonable” in order for section 68 to apply. The Court of Appeal approved that standard, which is consistent with a literal reading of the Gabco test and inconsistent with an average reasonable person test.

The Supreme Court’s decision in Golden itself deferred to the business judgment of a single sophisticated taxpayer—Nelson Skalbania—whose idiosyncrasies were well known. This is consistent with a literal reading of the Gabco test, and may well go beyond the finding that was required by the facts in TransAlta.

The Gabco test is consistent with the purposes of section 68; and with the Supreme Court of Canada’s emphasis in Canada Trustco, Fundy Settlement v. Canada,70 and elsewhere on the importance of predictability in the application of the Act. An average reasonable person test would be inconsistent with the requirement of predictability by expanding judicial discretion as to when section 68 should apply.

The Court of Appeal in TransAlta went on to hold that the Tax Court erred by not placing more weight on industry practice, valuation practice, etc., and disagreed with the test articulated by the Tax Court on the basis that it is complex and sets out no guiding principles. It is a test based partly on form, which allowed [the trial judge] to substitute his own subjective allocation for that agreed upon by the parties in compliance with industry and regulatory standards.71

70 Fundy Settlement, supra note 5.
71 TransAlta, supra note 1 (FCA), at paragraph 81.
This holding is consistent with the importance of predictability. The Court of Appeal concluded that had the Tax Court judge properly applied the reasonableness test for section 68,

he would have been compelled to consider industry and regulatory standards, as well as accounting and valuation theory, which all point in the direction of the agreed allocation. That agreed allocation was reasonable precisely because of its compliance with industry and regulatory norms and its consistency with standard valuation theory for regulated businesses and standard accounting principles applied in such industries.72

The emphasized text in this passage contains the only reference to consistency or predictability in the Federal Court of Appeal’s judgment. Specifically, according to the court, consistency with valuation practices and industry standards provides reference points that taxpayers can use to reliably determine when their agreed-upon valuation may be subject to section 68. This illustrates a theme with regard to the application of business principles and business judgment that appears elsewhere in the tax case law.73

In obiter dicta, the Court of Appeal noted that while a purchase price allocation agreed upon between parties to an arm’s-length transaction is an important factor, the weight given to such an agreement will vary according to the circumstances. Where the parties have strongly divergent interests, the allocation will be given considerable weight, whereas if one of the parties is indifferent or where both parties’ interests are aligned with the allocation, it will be given less weight. This finding reframes the arm’s-length negotiation cases within the Gabco test as one way in which the reasonable person test may be satisfied. It is also generally consistent with the Supreme Court’s decision in Golden and the post-Golden case law.

While a separate arm’s-length test, or safe harbour, would create additional certainty, the breadth of the reasonableness test set out in Gabco and its application in cases such as TransAlta should provide adequate protection for most taxpayers who have bargained at arm’s length with regard to a purchase price allocation.

The Court of Appeal did not refer to either the legal or the practical onus of proof. Accordingly, the way in which the case law works in that regard, as summarized above, continues to be applicable.

IMPLICATIONS FOR FUTURE SECTION 68 CASES

Generally speaking, the Federal Court of Appeal’s ruling in TransAlta provides welcome relief from the uncertainty created by the Tax Court’s judgment and sets out the most certain, predictable, and fair basis to date for the application of section 68.

72 Ibid., at paragraph 82 (emphasis added).
The development of a reasonableness test for section 68 based on *Gabco* is particularly noteworthy. This test generally defers to arm’s-length taxpayers’ price allocations, and puts a heavy practical onus of proof on the Crown to establish that purchase price allocations are unreasonable before section 68 will apply. This makes the application of section 68 more predictable, and accordingly decreases judicial and ministerial discretion.

It is important to note that the Federal Court of Appeal’s statement of the test for the application of section 68 in *TransAlta* is not limited to purchase price allocations to goodwill. Rather, it should be relevant to section 68 generally, and accordingly can be applied in arm’s-length cases as follows:

- In cases involving goodwill, it should not be necessary, as a first step, to identify goodwill using the modified legal test articulated by the Court of Appeal. Rather, the first step in the analytical process should be to apply the reasonableness test. This is important because it can be done in most cases without the assistance of legal counsel or other experts, thereby dramatically improving cost-effective predictability from the perspective of both the taxpayer and the Crown.

- The reasonableness test precludes the application of section 68 if the purchase price allocation would have been agreed to by a reasonable person, bearing business considerations in mind. Facts such as those in *Golden* and *TransAlta* must be presumed to satisfy that test, whereas facts like those in *Petersen* exemplify how unreasonable a purchase price allocation must be to fail the same test.

- The taxpayer bears the legal onus to adduce evidence sufficient to overturn the Crown’s assumptions on the balance of probabilities. Examples of this kind of evidence are provided below.

- As the taxpayer adduces evidence to support the reasonableness of his purchase price allocation, the practical onus of proof shifts to the Crown. As a result, the Crown must adduce evidence of its own, or alternatively discredit the evidence provided by the taxpayer, and by so doing, establish that the purchase price allocation is unreasonable on the balance of probabilities. If the Crown falls short, the taxpayer should win by default.\(^74\)

- The trial judge will consider all of the relevant circumstances and determine, on a balance of probabilities, whether the purchase price allocation is clearly unreasonable. If doubt remains, this inquiry should be resolved in the taxpayer’s favour.\(^75\)

A taxpayer may provide a variety of evidence to satisfy section 68’s reasonableness test as it is set down by *TransAlta*. For example:

\(^74\) Sullivan, supra note 4, at 534-35.

\(^75\) *Gabco*, supra note 61.
If the purchase price allocation is consistent with industry standards or valuation principles, then section 68 should not apply. Any allocation to an asset that is permitted on audited financial statements should not be subject to section 68 since the price allocation presumably meets the valuation tests used by audit firms, and thus should easily pass the reasonable person test. As little as one comparable transaction, entered into by the kind of reasonable person described above, should be sufficient to exclude section 68. Arm’s-length negotiation with regard to the purchase price allocation is an indicator of reasonableness, the strength of which will vary with the circumstances. Where one party has no motivation to bargain because, for example, the allocation has little financial impact on her, this factor may be weak. Where both parties have something material to gain or lose as a result of the price allocation, this factor may be determinative. If the parties are sophisticated with regard to the kind of transaction in question, this may be enough to avoid section 68, as it was in *Golden*. The reasonable person need not be actual. Rather, if it is reasonable to assume that some taxpayers in similar circumstances would use similar purchase price allocations, that should be sufficient to exclude section 68. Finally, where goodwill is identified using the modified legal test articulated by the Court of Appeal, it should not be broken down into its component parts for valuation purposes. Rather, any valuation of goodwill should use the residual method of valuing goodwill, and in most cases, the reasonableness test should exempt arm’s-length parties from the application of section 68.

Cases like *Staltari* will still provide an interesting test for section 68. The settlement of litigation is a business consideration that regularly motivates assessments of value that deviate from fair market value. Furthermore, the parties in *Staltari* were relatively sophisticated, and it appears that they had materially opposing financial and taxation interests with regard to the allocation of the settlement proceeds. That is, the allocation of settlement proceeds to shares deprived the employer of a deduction at the same time as it provided the employee with a taxable capital gain instead of fully taxable employment income. This arm’s-length tension was referenced by the Supreme Court in *Golden* as a factor that should be counted on to move the parties toward a reasonable price allocation. *Staltari* also raises an interesting issue relative to the principle articulated by *TransAlta* and *Golden* that arm’s-length agreements should bear a great deal of weight in determining reasonableness. In *Staltari*, the terms of the arm’s-length agreement would cause the employer to lose a deduction, while the employee would receive preferential tax treatment on a capital gain. *Daishowa*, supra note 5 (SCC), is not on point, it can also be used to support this aspect of *Staltari*.
shareholders’ agreement contradicted the terms of an arm’s-length settlement agreement. This distinguishes Staltari from H. Baur, where the taxpayer tried to overcome an arm’s-length agreement to allocate the purchase price on the basis of valuation evidence alone. It is my view that the arm’s-length settlement agreement in Staltari does not trump or even neutralize the earlier shareholders’ agreement. This factor would weigh in the balance on the side of applying section 68.

In my view, future cases like Staltari will probably be decided in favour of the taxpayer. The reasonableness test can be met by finding business people who for business reasons would allocate in more or less the same way as the parties did in Staltari. It will be possible in many cases to produce evidence to support this position, and that should outweigh other factors such as arm’s-length agreements or valuation evidence, which previously received too much weight, particularly in the pre-Golden case law. This approach illustrates the way in which TransAlta promotes the importance of predictability and reduces judicial discretion.

It is also interesting to consider the potential impact of the Supreme Court of Canada’s decision in Fundy Settlement on future section 68 cases. Arguably, the requirement in that case that the party arguing for the exercise of judicial discretion provide “good reasons” for that exercise should make it more likely that borderline section 68 cases will be decided in favour of taxpayers. It is my view that this is consistent with TransAlta’s adoption of the Gabco reasonable person test, and its endorsement of the rule in Petersen that the purchase price allocation must be clearly unreasonable in order for section 68 to apply.

**CONCLUSION**

The Federal Court of Appeal ruling in TransAlta provides a principled interpretation of section 68 that is generally consistent with the case law post-Golden. Of particular importance is the court’s articulation of the reasonableness standard on which the application of that section depends.

TransAlta also provides a textbook illustration of the way in which the importance of predictability in the interpretation of the Act should be balanced against judicial discretion. The court rejected a legalistic test that would have created great uncertainty for future cases, in favour of a test that is consistent with taxpayer expectations based upon the exercise of reasonable business judgment. This follows the Supreme Court of Canada’s emphasis in Canada Trustco on the importance of consistency, certainty, predictability, and fairness from the taxpayer’s perspective.

TransAlta therefore continues what is in my view a constructive trend—our highest courts’ increasing tendency to interpret the Act in a manner that is consistent with reasonably exercised business judgment as opposed to legalistic tests. This should reduce litigation time and expense, and is to be applauded for that reason.

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78 Fundy Settlement, supra note 5.
79 Ibid., at paragraph 16.
The Importance of Family Resemblance: Series of Transactions After Copthorne

Benjamin Alarie and Julia Lockhart*

P R É C I S
Le concept de « série d’opérations » était un élément clé dont traitait la décision de la Cour suprême du Canada dans l’arrêt Copthorne Holdings Ltd. c. Canada. À la suite de cette décision, le présent article examine les commentaires précédents sur le sujet et suggère une nouvelle approche fondée sur le concept de « ressemblance familiale ». La ressemblance familiale se fonde sur le principe qu’il n’y a pas d’éléments essentiels qui soient les mêmes dans chaque série d’opérations visée par un article. En revanche, une série d’opérations devrait se définir en rapport à l’objectif de la disposition anti-évitement en question et à la série d’opérations stylisée que le Parlement tentait de cerner. Lorsqu’il y a une ressemblance familiale suffisante entre la série stylisée et les opérations effectuées, on devrait constater qu’il y a une série. Ce concept est appliqué aux règles anti-évitement spécifiques et à la règle générale anti-évitement. L’article traite de la façon dont la Loi pourrait être clarifiée par des modifications inspirées du concept de ressemblance familiale.

A B S T R A C T
The concept of a series of transactions was a key issue in the Supreme Court of Canada’s decision in Copthorne Holdings Ltd. v. Canada. In light of that decision, this article reviews previous commentary on the topic and suggests a new approach based on the concept of family resemblance. Family resemblance recognizes that there are no core aspects that are the same in every series captured by a provision of the Income Tax Act. Rather, a series should be defined in relation to the purpose of the anti-avoidance provision in issue and the stylized set of transactions that Parliament was attempting to capture. Where there is a sufficient family resemblance between the stylized series and the transactions carried out, a series should be found. This concept is applied to both specific anti-avoidance rules and the general anti-avoidance rule. The article suggests how the Act could be clarified through amendments inspired by the concept of family resemblance.

KEYWORDS: SERIES OF TRANSACTIONS ■ STATUTORY INTERPRETATION ■ GAAR ■ BUTTERFLY TRANSACTIONS ■ PURPOSE

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INTRODUCTION

The concept of a “series of transactions” is used in various Commonwealth jurisdictions and specifically, for our purposes in this article, in a number of provisions in Canada’s Income Tax Act. The general use of the series concept in the Act is to expand the reach of anti-avoidance rules and to limit the availability of particular tax benefits that might otherwise be claimed. Currently, transactions that are found to be part of a series are accorded different (and generally less attractive) treatment than transactions that fall outside a series in a number of contexts, including the general anti-avoidance rule (GAAR), section 55, and the bump denial rules.

The concept of a series of transactions has been a challenging one for the courts and for commentators to unpack to date, not least because of the diverse contexts in which it appears in the Act. Its inclusion in so many provisions and the somewhat different roles that it is required to play in those various contexts are seemingly in

1 In this article, we use the terms “series of transactions” and “series” interchangeably, with the context indicating whether the reference is to the statutory or common-law version of the concept.

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.
tension with the singular definition of “series of transactions” in subsection 248(10), which is ostensibly intended to apply for the Act as a whole. Indeed, this issue is expected to become even more important, given that the series concept will be relied on in considerably more provisions in the future. Amendments made to the Act with the enactment of Bill C-45, in late 2012, add the phrase “series of transactions” in numerous new anti-avoidance contexts. This increasing reliance on the series concept suggests that our article is particularly timely. If, until now, there was room to argue that the term “series of transactions” must be given a single, context-independent meaning throughout the entire Act, in accordance with the definition in subsection 248(10), the proliferation of its use in the recent amendments strongly suggests otherwise. Indeed, the importance of recognizing that the meaning of “series of transactions” must be sensitive to the context and purpose of the various statutory uses of the term has never been greater. In this article, we explain how to approach the series concept in a way that is as reliable as possible and also contextually sensitive.

In the last 30 years, several cases and commentators have explored the boundaries and implications of the concept of a series of transactions. In this article, we take the opportunity afforded by the recent Supreme Court of Canada decision in *Copthorne Holdings Ltd. v. Canada* to reflect on and critically review that literature, as well as offer our own judgment on where things now stand in Canada with respect to the interpretation and use of the series concept. Ultimately, we argue that a key (if not the key) factor in determining whether or not a series exists under a textual, contextual, and purposive analysis should be whether the transactions undertaken by a taxpayer bear a “family resemblance” to the sets of transactions that Parliament can reasonably be considered to have had in mind when it enacted the provision (or provisions) at issue in a given case. We also demonstrate and explain how a family resemblance approach can be used to reach sensible legal results in the various instances in the Act in which the concept of a series of transactions is invoked, including how the family resemblance approach applies in the context of GAAR.

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3 Subsection 248(10) states, “For the purposes of this Act, where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series.”

4 Bill C-45 was enacted as the Jobs and Growth Act, 2012, SC 2012, c. 31; royal assent December 14, 2012. This legislation amends the Act to include the following provisions (among others) that invoke the concept of a series of transactions: new section 17.1 (relating to deemed interest under sections 15 and 212.3); new subsection 97(3) (denying a section 88 election to partnerships in certain circumstances); amended section 100 (addressing dispositions of partnership interests to tax-exempts or non-residents); new definitions of “advantage” and “RCA strip” in subsection 207.5(1); new section 207.63 (establishing joint liability for custodians of retirement compensation arrangements in certain circumstances); new section 207.64 (granting the minister power to waive liability to tax under new sections 207.61 through 207.63); new section 212.3 (addressing foreign affiliate dumping); new subsection 219.1(2) (relating to foreign affiliate dumping in the context of a corporate emigration); and new subsection 247(12) (relating to transfer-pricing adjustments).

5 2011 SCC 63.
The discussion that follows is divided into six parts:

- Part one sets the stage by outlining the facts in Copthorne.
- Part two discusses the relationship between the common-law definition of series and the explicit definition in subsection 248(10), and briefly describes the common-law meaning of the term endorsed by the Supreme Court of Canada in Copthorne.
- Part three addresses what we know, following Copthorne, about the statutorily extended meaning of series and, more specifically, the construction of the phrase “in contemplation of.”
- In light of the foregoing, part four argues that the approach of the courts to date has been too textual and narrow, and has not lived up to the requirement that the Act be given a “textual, contextual and purposive” interpretation. In our view, the interpretive analysis should be broadened to include purposive elements that draw upon the particular work that Parliament can reasonably be taken to have wished the series concept to perform in the various contexts in which it is used. More specifically, we explain how the use of a “family resemblance” test to assist in determining the appropriate legal boundaries of a series resolves a number of conceptual issues, provides a principled way to approach the interpretation of the term, accounts for the various indicia that the courts have drawn upon to date, and avoids the theoretical menace of overinclusive and statutorily unintended series.
- Part five explores the possibility that, given the difficulty that the courts have had with the series concept to date, in the interests of “predictability, certainty and fairness” it may be advisable for Parliament to provide additional guidance to assist courts in arriving at appropriate applications of the series concept. As we explain, although it may be possible to use the family resemblance test that we advocate through a more general exercise of textual, contextual, and purposive statutory interpretation, a more reliable possibility would be for Parliament to expand upon or revise the current statutory definition of series in subsection 248(10). The statutory amendment route may be particularly advisable in light of the new reliance on series in the recent amendments to the Act.
- Part six presents our concluding comments.

THE FACTS IN COPTHORNE

The facts in Copthorne were relatively complex but may be summarized as follows. The Li family held shares in Big City Project Corporation B.V. (“BV”), a corporation constituted under the laws of the Netherlands. BV owned all of the shares of Copthorne Holdings Inc. (“Copthorne I”), an Alberta corporation. Copthorne I

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6 See Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54, at paragraph 47.
7 See ibid., at paragraph 31.
had realized a significant capital gain upon the disposition of a hotel property in 1989, and the proceeds from the sale had been invested in a Barbadian corporation, Copthorne Overseas Investment Ltd. ("COIL"), which carried on a bond-trading business.

The Li family also held all of the shares of VHHC Investments Inc. ("VHHCI"), a corporation constituted under the laws of Canada. The paid-up capital (PUC) of the shares of VHHCI was $96.7 million, $67.4 million of which had been used to subscribe for shares of a wholly owned subsidiary, VHHC Holdings Ltd. ("VHHCH"). VHHCH had in turn used the money to invest in shares of a Canadian public company through a wholly owned subsidiary. In 1992, after the value of that investment decreased dramatically, VHHCI transferred its shares of VHHCH to Copthorne I as part of a loss-utilization transaction. By that time, the shares of VHHCH had only nominal fair market value.

In January 1993, it was decided that Copthorne I, VHHCH, and two other companies in the Li family group should be amalgamated in order to simplify the group's structure and permit further loss utilization. Because VHHCH was Copthorne I's subsidiary, however, an amalgamation of the two corporations would have caused the $67.4 million of PUC in respect of VHHCH's shares to be cancelled under the Alberta Business Corporations Act. In order to prevent this result, Copthorne I sold its VHHCH shares to BV on July 7, 1993 for nominal consideration ("the 1993 share sale"), making VHHCH Copthorne I's sister corporation. On January 1, 1994, VHHCH, Copthorne I, and the two other corporations amalgamated, creating a new corporation ("Copthorne II"). The PUC of Copthorne II's share capital was approximately $67.4 million, an amount that was almost entirely attributable to the PUC of the VHHCH shares.

In late 1994, the Li family decided to repatriate the funds used by COIL to carry on its bond-trading business as a result of the Department of Finance's proposal to introduce changes to Canada's foreign accrual property income (FAPI) regime, which would have subjected the income from the bond-trading business to tax in Canada. The shares of VHHCI and Copthorne II were sold to a Li family corporation constituted under the laws of Barbados ("LF Investments"), and on January 1, 1995, VHHCI and Copthorne II amalgamated, forming another corporation ("Copthorne III"). Upon the amalgamation, LF Investment's shares in VHHCI and Copthorne II were converted into 1,000 common shares of Copthorne III and 164 million class D preferred shares. Each of the common shares and the class D preferred shares had a PUC of $1, for a total of $164.1 million of PUC (made up of $96.7 million of PUC attributable to VHHCI's shares plus $67.4 million of PUC attributable to the shares of Copthorne II), and the class D preferred share were redeemable for $1 per share. COIL transferred $142 million to Copthorne III in the form of a tax-free return of capital, and Copthorne III redeemed 142 million class D preferred shares held by LF Investments ("the 1995 redemption"). Since the redemption proceeds received by LF Investments in respect of each class D preferred share did not exceed the PUC of the share, Copthorne III was not deemed to have paid any dividend to LF Investments pursuant to subsection 84(3).
The minister reassessed Copthorne III on the basis that $58 million of the redemption proceeds should be characterized as a dividend subject to withholding tax under GAAR. According to the Crown, the avoidance transaction was the 1993 share sale. The tax benefit realized (the avoidance of tax upon the repatriation of funds by Copthorne III), however, had occurred only as a result of the 1995 redemption. Thus, subsection 245(2) could apply to the 1993 share sale only if that transaction was part of the same series of transactions as the 1995 redemption. It was agreed by both parties that the transactions carried out in 1993 (the 1993 share sale and the January 1, 1994 amalgamation of VHHCH, Copthorne I, and two other corporations) formed a series of transactions. Moreover, the Crown conceded that the 1995 redemption did not form part of that series. Thus, the only question was whether the 1995 redemption was a related transaction completed in contemplation of the series within the meaning of subsection 248(10).

**COMMON-LAW SERIES**

It is generally accepted that there are two aspects of the definition of series for the purposes of the Act: the common-law definition and the statutory expansion under the definition offered in subsection 248(10). While some commentators have questioned whether the definition in subsection 248(10) does in fact expand upon the common-law meaning of series of transactions, the Supreme Court in *Copthorne* has confirmed the distinct existence of both the common-law series and the expanded statutory series. In this part of the article, we trace the development of this distinction through the cases and the commentary before briefly concluding on the current understanding of the common-law meaning of series.

The earliest cases on series of transactions did not refer to common-law series and subsection 248(10) series, in part because subsection 248(10) was only enacted in 1985. In *Osfc Holdings Ltd. v. Canada*, however, Rothstein JA (at that time serving on the Federal Court of Appeal) became the first to draw a distinction between the two concepts. He defined a common-law series as a sequence of transactions each of which must be pre-ordained to produce a final result. Pre-ordination means that when the first transaction of the series is implemented, all essential features of the subsequent

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8 The minister took the view that the total PUC attributed to the 164 million class D preferred shares should have been $96.7 million (that is, that no amount attributable to the shares of VHHCH should have been included). As a result, each of the 164 million class D preferred shares had a PUC of approximately $0.59, resulting in a deemed dividend of $0.41 (that is, $1 − $0.59) per share, or $58 million ($0.41*142 million shares) in total.

9 See supra note 3.


11 2001 FCA 260. Rothstein JA was joined in his reasons for judgment by Stone JA; Letourneau JA wrote separate dissenting reasons.
transaction or transactions are determined by persons who have the firm intention and ability to implement them. That is, there must be no practical likelihood that the subsequent transaction or transactions will not take place.12

According to Rothstein JA, the effect of subsection 248(10) was to expand this definition. While one could read subsection 248(10) as merely restating the common-law test for a series of transactions, Rothstein JA concluded that a broader reading was more appropriate.13 In his view, reading subsection 248(10) as an expansion was preferable for three reasons:

- First, the language included in the definition did not track the language used in the cases from the United Kingdom that he held were the jurisprudential basis of the common-law definition. Since Parliament was aware of those cases and officials involved in the drafting had made explicit reference to them, Rothstein JA concluded that the choice of different language reflected a deliberate effort to expand the definition.14
- Second, Rothstein JA considered the effect of certain transitional rules with respect to the implementation of GAAR. Those rules excluded transactions from the scope of GAAR so long as the transactions were part of a series that predated GAAR, but also excluded the application of subsection 248(10) in determining that series. Rothstein JA held that it would be inconsistent to read subsection 248(10) as merely restating the common-law test, since the exclusion of that provision from the application of the transitional rules would then be meaningless.15
- Finally, Rothstein JA held that Parliament’s decision to use the word “deem” in subsection 248(10) made that subsection a deeming provision, and deeming provisions usually play “a function of enlargement.”16

The Supreme Court of Canada endorsed this reading of subsection 248(10) when the court considered GAAR in Canada Trustco Mortgage Co. v. Canada,17 prior to Rothstein JA’s elevation to that court. More specifically, the Supreme Court in Canada Trustco affirmed the reasoning of Rothstein JA in OSFC Holdings that the effect of subsection 248(10) was to “extend” the common-law definition of series.18

Kandev, Bloom, and Fournier have argued that reading subsection 248(10) as expanding the common-law definition of series is incorrect.19 Their criticism is based

12 OSFC, supra note 11, at paragraph 24.
13 Ibid., at paragraph 34.
14 Ibid., at paragraph 31.
15 Ibid., at paragraph 32.
16 Ibid., at paragraph 33.
17 Supra note 6.
18 Ibid., at paragraph 26.
19 Kandev et al., supra note 10, at 279.
on (1) the context in which the common-law series definition was developed, (2) the words in the Act, and (3) the policy implications of having such a broad definition of series. With respect to the first of these, Kandev et al. note that the definition of series that was developed in the United Kingdom was developed in the course of a judicial anti-avoidance doctrine. This, they observe, is in contrast to the Canadian definition, which applies throughout the Act and not just with respect to GAAR.20 The judicially designed rule in the United Kingdom was intended to fit within a specific test, whereas the Canadian series concept is intended to be more versatile, since it is relevant to multiple sections of the Act. The distinctive context of the UK rule has been addressed by the Canadian courts, notably in Canada v. Canadian Utilities Ltd.21 In that case, the Federal Court of Appeal rejected the taxpayer’s argument that because a transaction had an independent life, it could not form part of a series of transactions. Rothstein JA noted that the UK approach was not to be imported in its entirety to Canada since “[t]he Canadian approach is one of statutory rather than judicial anti-avoidance measures.”22

With respect to the second basis for criticism, the textual one, the argument put forward by Kandev et al. is weaker. It relies on the distinction between the text of subsection 248(10) (“where there is a reference to a series of transactions or events, the series shall be deemed to include”) and what Kandev et al. refer to as the more typical deeming language (“a series of transactions or events shall be deemed to include”).23 The difference between these two constructions is minimal, and the use of the word “deem” strongly suggests an intention on the part of Parliament to include in the meaning of series facts or circumstances that would not be captured by the common-law meaning.24

With respect to the third objection, Kandev et al. argue that the purpose of subsection 248(10) is merely to bring into the Act the common-law meaning of series;25 however, that view is not one that is widely held. Duff has endorsed the distinction between the common-law series and the extended series under subsection 248(10).26 Similarly Carr and Milot’s commentary on the series concept accepts the distinction

20 Ibid., at 285.
21 2004 FCA 234.
22 Ibid., at paragraph 56.
23 Kandev et al., supra note 10, at 310.
24 “The most important use of ‘deems’ is to create a legal fiction: a given fact ‘x’ is declared to be ‘y’ or is to be dealt with as if it were ‘y’ for some or all purposes.” Ruth Sullivan, Sullivan on the Construction of Statutes, 5th ed. (Markham, ON: LexisNexis Canada, 2008), at 86.
25 Kandev et al., supra note 10, at 309-12.
between the common-law series and the expanded definition of series of transactions in subsection 248(10). Our own view, shared by these commentators as well as by the Supreme Court of Canada in Canada Trustco, is that the purpose of subsection 248(10) is to expand upon the common-law concept of series of transactions.

In Copthorne, the Supreme Court again stated that the “common law series is expanded by s. 248(10) of the Act.” Accordingly, the two-part structure of the definition of series in Canadian tax law seems certain to persist, despite the force one might accord to Kandev et al.’s criticism. This is perhaps even more likely given the elevation of Rothstein J to the Supreme Court of Canada and the court’s historically strong reliance on its tax experts to guide the development of its approach to tax appeals. The court in Copthorne also confirmed the definition that it had accorded to the definition of series from the early cases. Thus, after the decision in Copthorne, the common-law test for a series of transactions should be regarded as remaining unchanged from OSFC and Canada Trustco.

STATUTORILY EXTENDED DEFINITION OF “SERIES”

The Supreme Court’s discussion about a series of transactions in Copthorne was concerned primarily with the interpretation of subsection 248(10). Subsection 248(10) deems a series of transactions to include “related transactions or events completed in contemplation of the series.” Given the relative lack of controversy over the meaning of a common-law series (essentially, that of “preordination”), much of the recent case law and commentary since OSFC has focused on how subsection 248(10) should be applied and what meaning should be given to the expressions “related transactions or events” and “in contemplation of.” This part of the article discusses the impact that the Supreme Court’s judgment in Copthorne is likely to have on these interpretive questions.

Meaning of “Related Transactions or Events”

Subsection 248(10) contains two key textual elements: “related transactions or events” and “in contemplation of.” Most of the cases have focused on the meaning of “in contemplation of,” while paying comparatively little attention to the meaning of “related transactions or events.”

28 Copthorne, supra note 5, at paragraph 43.
30 See OSFC, supra note 11, and the text accompanying note 12, supra; and Canada Trustco, supra note 6, at paragraph 25 (citing Craven v. White, [1989] AC 398, at 514 (HL), per Lord Oliver; and W.T. Ramsay v. Inland Revenue Commissioners, [1981] 1 All ER 865 (HL)).
31 See supra note 3.
of “related transactions or events.” Indeed, none of the cases involving subsection 248(10) explicitly purports to define “related transactions or events” as an independent element.\(^{32}\) The courts seem to have simply taken the view that a transaction is related to a series where it is carried out in contemplation of that series. In other words, the courts appear to have effectively read subsection 248(10) as though it had used the words “related in the sense of having been completed in contemplation of the series.”

This interpretation is arguably inconsistent with the principle of statutory interpretation to the effect that Parliament does not speak without reason.\(^ {33}\) It effectively leaves no work to be done by the word “related.” Nevertheless, given the absence of any comment on the issue by the court in Copthorne, for now at least, “in contemplation of” appears to be the standard required for transactions to be “related” under subsection 248(10). The meaning that the courts have ascribed to “in contemplation of” is therefore critical to understanding the subsection.

**Meaning of “in Contemplation of”**

As discussed in more detail below, “contemplation” has been given various meanings by the courts. In OSFC, the Federal Court of Appeal adopted a test based on knowledge and taking the series into account. The Supreme Court in Canada Trustco revised this test to focus on whether the transaction was done “because of” or “in relation to” a series. This “because of or in relation to” standard has been further interpreted by the courts using, variously, a “strong nexus” test, a “motivating factor” test, and a “more than a mere possibility” test.

**Knowledge and Taking into Account**

Rothstein JA in OSFC was the first to interpret the phrase “in contemplation of” in a detailed way. He held that a transaction was completed in contemplation of a common-law series 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.”\(^ {34}\) This test appears to rely on two findings: (1) that there was knowledge of the transactions making up the common-law series, and (2) that the knowledge of the transactions making up the common-law series was taken into account by the

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32 On the other hand, it should be noted that in OSFC, supra note 11, at paragraph 36, Rothstein JA wrote, “As long as the transaction has some connection with the common law series, it will, if it was completed in contemplation of the common law series, be included in the series by reason of the deeming effect of subsection 248(10) [emphasis added].” This may suggest that Rothstein JA was of the view that the word “related” should be interpreted as “bearing some connection.” This would not appear to leave a large role to play for the word “related,” since presumably the fact that a transaction is carried out in contemplation of a series connects it with that series.

33 See, for example, R v. D.A.I., 2012 SCC 5, at paragraph 31.

34 OSFC, supra note 11, at paragraph 36.
taxpayer. The first aspect seems fairly straightforward as a simple knowledge requirement. The second aspect appears to be a type of purpose or linkage test, of the same kind that Brender has suggested is required for a common-law series.35

When OSFC was decided, the first aspect of the test, the knowledge requirement, proved to be especially controversial. Duff argued that an expanded test for series that relied on an actual knowledge threshold would be too narrow, since a party who was involved in only some (rather than all) of the transactions could argue that he did not have knowledge of the earlier series.36 Accordingly, in Duff’s view, the actual knowledge threshold was too demanding. By contrast, Brender argued that knowledge alone is too low a threshold.37 He would prefer a test that established a standard based on a common purpose.38 Similarly, Kandev et al. viewed the knowledge test as overly broad, since people can be assumed to always have knowledge of all their prior transactions;39 in other words, a knowledge test would effectively incorporate all prior transactions into a series.

The contrast among these commentaries is striking. To some extent it has to do with the perspective from which one is assessing the transactions: Which party must have knowledge of which transactions in order for transactions to constitute a series? Duff, who was focused on the facts in OSFC, was concerned with cases where two parties were involved and one party had undertaken a number of packaging transactions in order to permit the second party to access a tax benefit.40 On those facts, it is possible to imagine that if an actual knowledge test were to apply, the second party might lack the degree of knowledge required with respect to the earlier transactions. By contrast, both Brender and Kandev et al. were more concerned with situations where all the transactions were carried out by the same taxpayer. In those circumstances, the knowledge threshold would be easily established in every (or almost every) case, assuming that the test was applied retrospectively (as the courts have permitted, including, recently, the Supreme Court in Copthorne).

Perspective of application (that is, which party must have the knowledge) is an issue that the courts have not confronted directly in any of the decisions on the meaning of series. Largely this is because the knowledge requirement that was first described in OSFC has been effectively subsumed into the linkage or connection test. Indeed, as the Supreme Court stated in Canada Trustco, “‘in contemplation’ is read not in the sense of actual knowledge but in the broader sense of ‘because of’ or ‘in

37 Brender, supra note 35, at 226.
38 Ibid.
39 Kandev et al., supra note 10, at 314.
relation to’ the series.” Nonetheless, the question of timing alluded to by the commentators above continues to be a significant issue in applying the concept of a series of transactions. While there is no knowledge requirement in the current formulation of the test, the retrospective application of the contemplation standard raises many of the same issues that concerned both Brender and Kandev et al. In particular, since past transactions are always more than mere possibilities and since most taxpayers can generally be considered to be aware of their past actions, it becomes more difficult to assert that a transaction occurring after a common-law series of transactions was not done in contemplation of that series. The issues related to timing and retrospective contemplation are discussed further below.

“Because of” or “in Relation to”

Rothstein JA’s definition of the subsection 248(10) series as set out in OSFC was considered briefly by the Supreme Court in Canada Trustco. As noted above, the court held that “‘in contemplation’ is read not in the sense of actual knowledge but in the broader sense of ‘because of’ or ‘in relation to’ the series.” Courts since Canada Trustco have struggled to enunciate a test for what level of connection constitutes “because of” or “in relation to” with respect to a series of transactions. In trying to determine what standard should be applied, courts have used a “strong nexus” test, a “motivating factor” test, and a “more than a mere possibility” test. All of these have been attempts to further define and refine the “because of” or “in relation to” standard. The Supreme Court commented on several of these approaches in Copthorne.

Before reviewing the court’s analysis of the meaning of “because of” or “in relation to,” it is worth noting the circularity in the approach that the Supreme Court has used so far in its interpretation of subsection 248(10). As mentioned above, the courts appear to have taken the view that the phrase “in contemplation of” is intended to guide taxpayers in determining which transactions are related and which are not. It seems unhelpful, therefore, to use the phrase “in relation to” in interpreting the meaning of “in contemplation of.” However, even if the word “related” in subsection 248(10) had an independent meaning, the “in relation to” test would mostly be redundant, since all (or nearly all) “related transactions” would presumably be considered to have been carried out “in relation to” a common-law series.

“Strong Nexus”

In Mil (Investments) SA v. The Queen, the Tax Court concluded that a “strong nexus” among transactions was required, since a lower threshold of mere possibility would leave too many transactions open to attack as forming part of a series. This strong nexus standard was applied by the Tax Court in Copthorne, where the trial judge found that a strong nexus did in fact exist between the common-law series that

41 Canada Trustco, supra note 6, at paragraph 26.
42 Ibid.
43 2006 TCC 460, at paragraph 65.
contained the avoidance transaction and the related tax-benefit transaction.44 The Tax Court held that this strong nexus existed because the subsequent transaction (the share redemption) was “exactly the type of transaction necessary to make a tax benefit a reality based on the preservation of the [paid-up capital].”45 On appeal, the Federal Court of Appeal found that the strong nexus test was too demanding, and substituted a requirement that the common-law series be a “motivating factor” for the related transaction.46 Finally, the Supreme Court agreed with the Federal Court of Appeal that a strong nexus was not required for a related transaction to be deemed to form part of the series.47 The Supreme Court went on to say, however, that a “mere possibility” was insufficient.48 As a result of Copthorne, then, we know that the required degree of connection for a transaction to be “because of” or “in relation to” a common-law series falls somewhere to the south of a strong nexus and somewhere to the north of a mere possibility. The meaning of “a mere possibility” is addressed below.

“Motivating Factor”

The Federal Court of Appeal in Copthorne held that while a strong nexus was not required for a transaction to be in contemplation of a series, the series must be a “motivating factor” for the transaction.49 The Federal Court of Appeal held that “if a series is a motivating factor with respect to the completion of a subsequent transaction, the transaction can be said to have been completed ‘in contemplation of the series.’”50 While the Supreme Court agreed with the Federal Court of Appeal that the strong nexus test was inappropriate, it did not endorse or comment on the “motivating factor” analysis, thus leaving some uncertainty as to the current legal status of that test.

“More Than a Mere Possibility”

While the Supreme Court in Copthorne rejected the strong nexus test and did not comment on the motivating factor test adopted by the lower courts, the court confirmed that a mere possibility that a transaction will occur is insufficient to establish a series under the “because of” or “in relation to” requirement for contemplation.51 Thus, it seems clear that if a party can successfully convince a court that subsequent transactions or events did not amount to anything more than a mere possibility,

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44 Copthorne Holdings Ltd. v. The Queen, 2007 TCC 481, at paragraph 39.
45 Ibid., at paragraph 40.
46 Copthorne Holding Ltd. v. Canada, 2009 FCA 163, at paragraphs 45-46.
47 Copthorne, supra note 5, at paragraph 47.
48 Ibid.
49 Copthorne, supra note 46, at paragraph 46.
50 Ibid.
51 Copthorne, supra note 5, at paragraph 47.
then that party can avoid having those transactions characterized as part of a series. The Supreme Court went on to find that on the facts of Copthorne, the connection between the series and the related transaction exceeded the requisite mere possibility threshold, and thus the court concluded that the subsequent transactions formed part of the earlier series.52

Unfortunately, the Supreme Court in Copthorne did not provide explicit reasons as to why it considered the subsequent transactions and events to be more than a mere possibility on the facts. The court did, however, cite the earlier Tax Court decision in MIL, which had used the mere possibility threshold to determine that no series existed.53 The taxpayer in MIL, a Cayman Islands corporation, held approximately 11.9 percent of the shares in a Canadian public company, Diamond Field Resources (“DFR”). In June 1995, MIL engaged in a share exchange transaction with Inco resulting in the reduction of its shareholding in DFR to just under 10 percent. In July 1995, MIL was continued into Luxembourg, becoming a resident of that country, in order to qualify for certain capital gains exemption benefits under article 13 of the Canada–Luxembourg tax treaty54 when Inco subsequently (in 1996) purchased all of the remaining shares in DFR (including MIL’s stake). The Tax Court concluded that transactions carried out in 1995 did not form part of the same series as the 1996 sale for the purposes of GAAR because, at the time of the initial transactions, the ultimate sale of MIL’s shares to Inco was no more than a mere possibility.55

Comparison of the facts in Copthorne and the facts in MIL has proved to be an interesting point for commentators. Most commentary from the private bar has praised the result in MIL (finding no series) while being more critical of the result in Copthorne (finding a series). Carr and Milot compare the facts in MIL and Copthorne in their commentary on the Tax Court’s Copthorne decision.56 They note that while there were some intervening events that changed the course of the transactions in MIL, the underlying motivation for the first series was clearly to set up better tax consequences for a subsequent transaction, even if the precise parameters of that subsequent transaction were unknown at the time of the series. In light of this fact, they question why the taxpayer in Copthorne should have been treated any differently from the one in MIL.57 Similarly, Kandev et al. consider both MIL and Copthorne to be examples of cases where the taxpayer engaged in “good strategic planning.”58 In an argument that we will develop in the next part of the article, one response to Carr

52 Ibid., at paragraph 58.
53 Ibid., at paragraph 47.
55 MIL, supra note 43, at paragraph 69.
56 Carr and Milot, supra note 27.
57 Ibid., at 260.
58 Kandev et al., supra note 10, at 325.
and Milot is that with the benefit of the decision of the Supreme Court in *Copthorne*, one might reasonably question whether the decision in *MIL* with respect to series ought to have been different in order to restore consistency of treatment of the taxpayer with *Copthorne*.

Indeed, despite the value provided by these comparisons of the decisions in *MIL* and *Copthorne*, the absence of detailed analysis by the Supreme Court on the facts in *Copthorne* means that there is still a gap in our understanding of what a merely possible transaction looks like relative to one that is sufficiently connected to form part of a series pursuant to subsection 248(10). While the guidance from the Supreme Court makes it clear that the facts in *Copthorne* were not merely a possibility, the court has not explained which aspects of the transactions made that the case. It is possible that *MIL* can be distinguished from *Copthorne* on the basis of the trial judge’s finding that at the time of the common-law series of transactions, MIL was actively taking steps to prevent the occurrence of the subsequent transaction, making for a more compelling case that the subsequent transaction was no more than a mere possibility (if that).\(^5\) That being said, MIL could surely have been expected to sell its shares in DFR one day, in the same way that it could be said that Copthorne could one day be expected to use the PUC it preserved by carrying out a horizontal amalgamation. Ultimately, it was virtually certain in both cases that the transactions planned for would eventually occur. Only the exact timing and circumstances of the transactions were unknown.

**Intervening Events**

Taxpayers resisting a finding of series often argue that some of the events that occurred between the time of the earlier transactions and the subsequent ones were such that they interfered with the supposed series. Indeed, the taxpayer in *Copthorne* argued that changes to the FAPI rules motivated its subsequent transaction rather than the earlier series. While the Supreme Court in *Copthorne* accepted that intervening events are relevant to the determination of whether there was a subsection 248(10) series,\(^6\) the court declined to accept the argument presented by the taxpayer that the introduction of the amendments to the FAPI rules qualified as an “intervening event” that should prevent subsection 248(10) from applying.\(^7\) In the court’s unanimous judgment, Rothstein J accepted the findings of the lower courts that the related transaction was exactly the type of transaction that was necessary to take advantage of the earlier series that had duplicated the PUC, and thus the intervening rule changes did not serve to break the series.\(^8\)

Unfortunately, the Supreme Court in *Copthorne* did not provide any guidance on what should qualify as an “intervening event” for the purposes of preventing a series

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60 Copthorne, supra note 5, at paragraph 47.
61 Ibid., at paragraph 48.
62 Ibid.
from existing. While the court did not provide any examples, a reasonably reliable (and uncommon) one would appear to be the death of an individual, such as happened in MIL with the death of one of the principal executives of DFR. In that case, the death led the board of directors of the company to decide to seek a buyer. That decision, in turn, ultimately led to the sale of DFR to Inco. The trial judge seems to have been particularly influenced by this event in arriving at the conclusion that no series of transactions existed in the case. The question is: What is the legally significant difference between the events in MIL and the introduction of the amendments to the FAPI rules in Copthorne?

One possible standard to consider for intervening events comes from the field of tort law: the concept of *novus actus interveniens*. According to this test, “if the intervening act was broadly within the scope of the foreseeable risk” created by the defendant’s negligence, the intervening act will not excuse the defendant from liability.63 Otherwise, it breaks the chain of causation between the plaintiff’s negligence and the damage suffered by the defendant. This is essentially a foreseeability test. Applying this test to the series concept would mean asking whether the intervening event was foreseeable at the time of the earlier transaction or series. If the event was foreseeable, it would not be sufficient to break the series. If the event was unforeseeable, it would break the series. This would explain why the death of one of the principal executives of DFR in MIL (which was clearly in its timing not reasonably foreseeable) qualified as an intervening event. It might not, however, explain the holding in Copthorne, since the introduction of the amendments to the FAPI rules was arguably also not reasonably foreseeable (though perhaps somewhat less so). Despite the possible lack of reasonable foreseeability, the Supreme Court refused to accept that the intervening event was sufficient to break the series in Copthorne.

### Length of Time Between the Series and the Related Transactions

The Supreme Court in Copthorne made it clear that the length of time between the common-law series and the related transactions or events may be one relevant factor in determining whether those transactions or events can form part of the series under subsection 248(10). In the court’s judgment, Rothstein J stated that “the length of time between the series and the related transaction may be a relevant consideration in some cases.”64

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64 *Copthorne*, supra note 5, at paragraph 47. See also the Federal Court of Appeal decision in *Copthorne*, supra note 46, at paragraph 51: “While approximately eighteen months elapsed between the 1993 Share Sale and the 1995 Redemption, the record indicates that the redemption was contemplated shortly after the introduction of the Proposed FAPI Amendments, indicating a time frame of something just over a year between the first event and the commencement of planning for the second event. While I do not wish to suggest that any particular length of time between a series and a transaction will be determinative of whether there is a sufficient
The courts have previously expressed a variety of views on what might count as a sufficient length of time to prevent a series from existing. In *Les Placements E. & R. Simard Inc. v. The Queen*, for example, Tardif J wrote that a 12-month interval constituted a “long period of time” for the purpose of determining whether a series existed.65 Similarly, in *Industries SLM Inc. v. MNR*, Archambault J suggested that intervals of 9 months and 33 months were relatively long for a common-law series.66 Finally, in *Copthorne* itself, Ryer J of the Federal Court of Appeal appeared to be of the view that while 18 months might be sufficient to prevent subsection 248(10) from applying, one year was relatively short.67

The Supreme Court did not provide any details in *Copthorne* as to what amount of time (if any) it considered sufficient to avoid the existence of a series. This is perhaps unsurprising, since further elaboration on this point would arguably have provided taxpayers with a road map for avoiding the application of provisions such as GAAR. Nevertheless, the court’s conclusion that the 1993 share sale and the 1995 redemption formed a subsection 248(10) series of transactions suggests that the justices did not believe that 12 to 18 months between transactions was a sufficiently long period in the *Copthorne* context to break the series.

**Timing and Retrospection**

Two particular timing issues are raised by subsection 248(10). The first question is whether the words “in contemplation of” may be applied both prospectively and retrospectively, or only prospectively. In other words, is it possible for subsection 248(10) to link a related transaction carried out after a series to that series on the basis that the taxpayer was contemplating the series at the time of the subsequent transaction? The second question is whether subsection 248(10) can link a transaction to a series carried out in contemplation of a related transaction (as opposed to just a related transaction carried out in contemplation of a series). In *Copthorne*, the Supreme Court was asked to comment on the first of these questions. The Crown argued that the 1995 redemption had been carried out in contemplation of the 1993 share sale. The taxpayer argued that this was irrelevant, since the real question was whether the 1993 share sale had been carried out in contemplation of the 1995 redemption. The taxpayer argued that the “in contemplation of” test could not be applied from the perspective of the subsequent transaction (or transactions).

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65 97 DTC 1328, at 1337 (TCC).


67 *Copthorne*, supra note 46, at paragraph 51.
In the Supreme Court’s decision, Rothstein J began by observing that the “common use” of “in contemplation of” was prospective. That being said, the definitions of “contemplation” set out in the *Oxford English Dictionary* (“[t]he action of contemplating or mentally viewing; the action of thinking about a thing continuously; attentive consideration, study”) and *Webster’s Third New International Dictionary* (“an act of the mind in considering with attention: continued attention to a particular subject . . . : something for which such consideration is asked . . . : the act of viewing steadfastly and attentively: the viewing of something . . . for its own sake”) were not exclusively confined to forward-looking interpretations. While Rothstein J acknowledged that one of the definitions in *Webster’s Third New International Dictionary* referred to “the act of looking forward to an event: the act of intending or considering a future event,” he was of the view that the more general definitions reproduced above were to be preferred. He also indicated that an interpretation of “contemplation” as both retrospective and prospective was more consistent with the intention of Parliament in enacting subsection 248(10), which in his view was clearly to broaden the notion of a series (as discussed above in the context of Rothstein JA’s judgment in *OSFC*). Finally, citing the following passage from *Canada Trustco*, he concluded that the court had already decided the issue:

The phrase “[in contemplation of]” can be applied to events either before or after the basic avoidance transaction found under s. 245(3). As has been noted:

> It is highly unlikely that Parliament could have intended to include in the statutory definition of “series of transactions” related transactions completed in contemplation of a subsequent series of transactions, but not related transactions in the contemplation of which taxpayers completed a prior series of transactions. (D. G. Duff, “Judicial Application of the General Anti-Avoidance Rule in Canada: *OSFC Holdings Ltd. v. The Queen*” (2003), 57 I.B.F.D. Bulletin 278, at p. 287)

Interestingly, it is not clear whether the above passage from *Canada Trustco* addressed the issue before the court in *Copthorne*. While the statement that the test may be applied to “events either before or after the basic avoidance transaction” might be interpreted as an endorsement of both prospective and retrospective applications of subsection 248(10), the quotation reproduced from Duff’s article (and particularly the reference to “related transactions in the contemplation of which taxpayers

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68 *Copthorne*, supra note 5, at paragraph 50.
69 Ibid., supra note 5, at paragraph 53.
70 Ibid.
71 Ibid., supra note 6, at paragraph 26 (quoted in *Copthorne*, supra note 5, at paragraph 55).
completed a *prior series* of transactions [emphasis added]”) suggests that the court in *Canada Trustco* was really dealing with the second question set out at the beginning of this section, namely, whether subsection 248(10) could be applied to a series carried out in contemplation of a related transaction. While the language of the provision suggests that this is not possible, the court appears to have been of a different view.73

Accepting a retrospective “in contemplation of” test also raises a number of issues in terms of its application. Retrospective application of the contemplation test is problematic since past transactions will nearly always be within the knowledge of the taxpayer and will assuredly be more than mere possibilities (and thus be within the taxpayer’s “contemplation”). As Kandev et al. point out, “the law presumes that persons intend the reasonable and probable consequences of their actions, and . . . prudent taxpayers would be expected to be cognizant of their past transactions when engaging in current ones.”74 It is hard to imagine a taxpayer not taking into account all of its prior transactions when engaging in tax planning, at least in the form of a comprehensive appreciation of the current state of the taxpayer’s affairs, which would, of course, be a result of all of those prior transactions.

There is also a certain tension between the Supreme Court’s finding that the words “in contemplation of” can apply retrospectively and its statements concerning the “more than a mere possibility” test. Bell J in *MIL* originally conceived of the test as one surrounding the interpretation of the words “in contemplation of” in subsection 248(10). The Supreme Court in *Copthorne* also appeared to consider the two to be linked, since it referred to that test in the course of its explanation of the “because of” or “in relation to” standard. Assuming that this is the correct approach, it may be that the “more than a mere possibility” test will be of assistance to taxpayers in future cases only where a related transaction precedes a series. Where the transaction occurs subsequently (as was the case in *Copthorne* and *MIL*), the series will necessarily be more than a mere possibility—it will have already occurred with certainty. This seems to us to be an unintended result of the decision, and is not consistent with the way the test was applied at the Tax Court and Federal Court of Appeal. Despite this, the only alternative appears to be for subsequent jurisprudence to delink the test from the “in contemplation of” language (though it is not clear what the textual basis for the test would be if this were done).

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73 This is the interpretation given to the passage from *Canada Trustco* by Brender, supra note 35, at 233, and Bell J, in *MIL*, supra note 43, at paragraphs 58-69, which concerned an attempt by the Crown to argue that a series had been carried out in contemplation of a subsequent related transaction. Bell J appeared to agree that this was possible in theory, but on the facts of the case, he concluded that the “in contemplation of” test was not satisfied (because the related transaction was a “mere possibility” at the time the series was carried out).

74 Kandev et al., supra note 10, at 314.
Legal reasoning requires us to characterize events as having certain legal attributes. In first-year contract-law classes, students and professors at law schools across North America discuss the circumstances in which interactions between negotiators will be characterized as legal “offers” that are capable of being legally “accepted” by another party, and what kinds of interactions will merely be “invitations” to make an offer. Courts have decided that placing goods on a shelf with a price tag attached does not amount to a legal “offer” to sell that item at that price, and are merely invitations to make an offer. It is the customer who makes an offer to buy the item at the indicated price when he or she presents the tagged item at the checkout. At common law, the cashier then has the option of either accepting or not accepting the customer’s offer. There are numerous similar examples throughout the law, of situations in which factual clarity does not lead to obvious legal characterization. Tax law is, of course, no different.

Tax law frequently requires taxpayers to legally characterize certain facts in particular ways. A taxpayer in a business setting who buys an asset for \( n \) and sells it a short time later for \( n + 1 \) must determine how to characterize the gain (1) on the sale. More specifically, in Canadian income-tax law, the gain must generally be characterized as either a capital gain or income from a business (for example, profit realized from “an adventure or concern in the nature of trade” under the extended meaning of “business” in subsection 248(1)). While the “capital” versus “income” characterization exercise is fundamental to the proper operation of the Act, its deployment is not always straightforward. The general trappings of transactions that give rise to capital gains, on the one hand, and the trappings of transactions that give rise to income from a business, on the other, are reasonably clear. It is inevitable, however, that there will be many borderline cases that will be difficult to resolve with any satisfaction. Indeed, in fact situations that are closely balanced in terms of the attributes that tend to point in the direction of capital gain and the attributes that tend to point in the direction of income from a business, as the Master of the Rolls, Sir Wilfred Greene, pointed out in 1937, “it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons.” Of course, despite the difficulty of making calls in borderline cases between capital and income, taxpayers, tax administrators, and the courts routinely make these calls through a process of reasoning by analogy to similar situations where the characterization has been decided in prior case law.

The same type of reasoning that allows, and indeed requires, lawyers and courts to decide whether an item with a price tag attached in a store is a legal offer (in

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75 See, for example, MNR v. Taylor, 56 DTC 1125 (Ex. Ct).

76 British Salmonco Aero Engines, Ltd. v. Commissioners of Inland Revenue (1937), 22 TC 29, at 43 (CA); quoted by the Supreme Court of Canada in Johns-Manville Canada v. The Queen, [1985] 2 SCR 46, at paragraph 13.
contract law) and whether a gain on the sale of an asset of a business is a capital gain (in tax law) applies in determining whether a particular set of events or transactions amounts to a “series of transactions” in a particular statutory setting.

Characterization: The Family Resemblance Concept

Deciding whether a set of events or transactions can be construed as constituting (or not constituting) a “series of transactions” for the purposes of a particular provision (or provisions) of the Act is an issue of legal characterization. It comes down to a yes or no determination, even though multiple criteria are often in play in making the characterization. The difficulty presented by the series concept is evident from the numerous tests (discussed earlier) that the courts have introduced, developed, and rejected over time. The purpose of this part of the article is to demonstrate some of the gaps in and problems with the current approach and to suggest an improvement in the framing of the legal issue in order to assist with its consistent treatment by the courts. More specifically, we will explain why the current approach taken to the characterization issue with respect to the definition of “series of transactions” in subsection 248(10) is too narrow, with the courts expending too much effort in analyzing the relationship between various steps of an alleged series of transactions, as opposed to examining the link between the elements of a purported series and the types of transactions that Parliament can reasonably be understood to have had in mind in invoking the series concept in the relevant statutory context. An approach based on the concept of “family resemblance” complements the series analysis adopted by the courts to date and ensures that that analysis will not yield inappropriate results. This approach accepts and essentially builds on Brender’s comment that the series concept “must be interpreted contextually and in light of the purpose underlying the particular provision in which it is invoked.”

To begin, what do we mean when we refer to family resemblance? Wittgenstein wrote about “family resemblance” in his work regarding the problem of categorizing and describing things using language. In *Philosophical Investigations*, he explained the family resemblance concept using the example of the category of “games.” He noted that there is no single element that is common to all things referred to as “games” (just as we would argue that there is no single element that all capital gains transactions or all trading transactions have in common):

> Look for example at board-games, with their multifarious relationships. Now pass to card-games; here you find many correspondences with the first group, but many common features drop out, and others appear. When we pass next to ball-games, much that is common is retained, but much is lost.—Are they all “amusing”? Compare chess with noughts and crosses [tic-tac-toe]. Or is there always winning and losing, or competition...

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77 Brender, supra note 35, at 210.
between players? Think of patience [solitaire]. In ball games there is winning and losing; but when a child throws his ball at the wall and catches it again, this feature has disappeared. Look at the parts played by skill and luck; and at the difference between skill in chess and skill in tennis. Think now of games like ring-a-ring-a-roses; here is the element of amusement, but how many other characteristic features have disappeared! And we can go through the many, many other groups of games in the same way; [we] can see how similarities crop up and disappear.79

According to Wittgenstein, all that games fundamentally share is a certain “family resemblance.” This concept may be of assistance in the context of provisions dealing with series. When Parliament uses the phrase “series of transactions” in the Act, it can reasonably be regarded as intending to apply the relevant provision to transactions that are of a certain type or family. The series concept is used as a means whereby Parliament can cast its anti-avoidance net wider in order to catch transactions that are similar in effect to the ones that are specifically thought of as being objectionable. Another way of thinking about this is that the series concept is often invoked as a pre-emptive strike against tax-avoidance strategies that build some extra steps into a prohibited transaction or set of transactions in order to avoid the application of the anti-avoidance provision. Sometimes Parliament will have a specific avoidance technique in mind; in other cases, the purpose is to catch an indeterminate variety of perhaps not clearly anticipated transactions. It is clear, however, that in drafting a particular provision, Parliament will never (or almost never) have had in mind the exact sequence of transactions entered into by the taxpayer. Thus, it will almost always be necessary to carry out some kind of comparison exercise in determining whether a particular anti-avoidance provision should apply to the taxpayer in a particular case. This is where the family resemblance concept comes into play in determining whether or not a series exists.

We are not the first to advocate for the use of a family resemblance test in tax law. In the context of characterizing hybrid foreign entities for Canadian income tax purposes, Milet has explained the idea of family resemblance as follows:

There is among legal experts a deeply ingrained tendency to assume that if in common legal usage different things are capable of being referred to by the same term, this must be because of some “essential” or “fundamental” characteristic that they all have in common. There is an alternative view, however, which is that if A, B, and C are all referred to by the same term, it is not necessarily because of a shared essence but may instead be because A and B have features in common, B and C have some but not all the same shared features, and A and C share a still different set of features in common. The various instances are linked together by overlapping and criss-crossing commonalities of characteristics, and it may be that there is no irreducible set of core characteristics that they all share. In this alternative view, the various instances of a general term’s application would be linked by, as Wittgenstein called them, “family resemblances”—the reference here being to the way that traits are shared by and dispersed among

79 Ibid., at paragraph 66.
members of a family: for instance, a girl has red hair and is short like her father and grandmother, while her brother, who is also red-haired, is tall like his blond mother. Despite having no single set of features in common, the various members viewed as a group may quite visibly belong to the same family. It can be helpful to think of various instances of a general term as being linked together by precisely such a network of criss-crossing similarities and differences.80

In our view, just as the family resemblance test is appropriate for the characterization of hybrid foreign entities for Canadian tax purposes, it will frequently make sense to apply a family resemblance approach to the use of the series concept in Canadian income tax law, for several reasons. First, its use is supported by the textual, contextual, and purposive approach to statutory interpretation repeatedly endorsed by the Supreme Court of Canada in recent years. That is, because the ordinary purpose of the invocation of the series concept in the Act is to counter variations of particular avoidance transactions, it makes sense—insofar as it is possible—to attend to the nature of the particular kind of avoidance transaction contemplated by Parliament in the provision that invokes the series concept. Second, there is a sense in which the family resemblance concept is consistent with the idea that, at bottom, the notion of a series requires that there be a certain relationship or connection between transactions. To be a series pursuant to the definition in subsection 248(10) for the purposes of a particular anti-avoidance rule, what the transactions must have in common (or, at least, one thing that they must have in common) is that they, considered collectively, amount to being of the type or from the family that Parliament can reasonably be considered to have had in mind in invoking the series concept in the particular statutory context at issue. Finally, and perhaps most importantly, we believe that a family resemblance approach prevents some of the potentially absurd results that could result from focusing only on the various interrelationships discussed in the case law to date among the various transactions in a sequence of events. That is, by attending to the nature of the family (or families) of transactions that the anti-avoidance provision is aimed at countering, one can avoid counterintuitive and surprising applications of anti-avoidance rules. Using a family resemblance test can promote certainty, predictability, and fairness in the use of the series concept.

The Family Resemblance Approach to “Series” in a Non-GAAR Context

Every series problem can essentially be reduced to a question about whether any subset of a given sequence of events constitutes a series of transactions for the purpose of applying a particular rule in the Act. Consider a generic set of facts in the form of a sequence of events: $E_1, E_2, E_3, \ldots, E_n, E_{n+1}, E_{n+2}$. The question that the series test fundamentally poses is whether any subset of those events should be characterized as forming a series for the purposes of a particular provision of the Act.

that invokes the concept. The traditional approach to resolving that problem and characterizing a series is to analyze the individual linkages between each of the events pursuant to the “related transactions or events” and “in contemplation of” aspects of the expanded statutory definition of series in subsection 248(10), discussed above.

The courts have typically asked whether $E_n$ was done in contemplation of the subset $E_1, E_2, \text{ and } E_3$ or whether $E_i$ was done in contemplation of $E_n, E_{n+1}, \text{ and } E_{n+2}$. This analysis gives rise to the problems that have consumed the attention of the courts, as described above. What does “contemplation” mean? When can contemplation be retrospective? What length of time between events can break a series? This approach expends too much effort in analyzing the connections between events (or an overly narrow set of connections between events) and not enough in analyzing the connections between and among the set of events as against the object, spirit, and purpose of the rule that invoked the series concept under consideration. If, at the outset in the interpretive process, more effort is spent on determining the object, spirit, and purpose with which the series concept is invoked in a particular provision (or provisions), the work of applying the concept in a particular factual circumstance will become easier (though not necessarily easy).

This leads us naturally to two questions:

- First, what precisely would be involved in the exercise of determining the purpose (or purposes) for which the series concept is invoked by a particular provision?
- Second, once the purpose (or purposes) is (are) identified, how, precisely, is the court to use such purpose(s) in the characterization exercise, drawing upon the idea of family resemblance?

With respect to the first question, a court should engage in a textual, contextual, and purposive exercise of interpretation, as endorsed by the Supreme Court of Canada. The text, context, and purpose are, of course, all relevant to the exercise of interpreting the purpose behind the invocation of the series concept in a particular provision. Where the text of a provision is not “precise and unequivocal,” the context and purpose have to bear additional weight. The term “series of transactions” does not admit of a precise and unequivocal interpretation, even with the benefit of the expanded statutory meaning offered in subsection 248(10). The challenge

81 The Supreme Court explained in Canada Trustco, supra note 6, at paragraph 10, that “[t]he interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words play [sic] a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.”
that the series concept has posed for the courts and commentators is clear evidence of this lack of precision. Thus, a court must look to the conventional sources in a contextually sensitive way in order to develop an understanding of the purpose or purposes behind the invocation of the series concept in a particular provision. This is, in many ways, akin to focusing on the “object, spirit and purpose” of the relevant provision in a manner consistent with Rothstein J’s explanation of how to go about finding the purpose of one or more provisions of the Act in the GAAR context.\footnote{See Copthorne, supra note 5, at paragraph 70.} In general, there are two ways by which courts may approach the identification of the purpose of a provision.\footnote{See David G. Duff, Benjamin Alarie, Kim Brooks, Geoffrey Loomer, and Lisa Philipps, \textit{Canadian Income Tax Law}, 4th ed. (Markham, ON: LexisNexis Canada, 2012), at 94.} The first and preferred approach is to rely on explanations in the statute itself. Unfortunately, the Act does not often provide explanations for its provisions directly. The second approach is to draw on “extra-statutory materials like commission reports, ministerial statements, government publications, or academic texts.”\footnote{Ibid.} Among these, some sources must be treated with caution (parliamentary debates and budget statements, because of their partisan nature), while others are more generally intended to be impartial (Department of Finance explanatory information and academic commentary).\footnote{Ibid., at 95.}

In many statutory contexts, the appropriate ambit of the series concept will be dependent on the particular reasons motivating the legislative reliance on the invocation of the concept, which will best be derived from reference to extrinsic materials. This will be even more the case with the statutory amendments associated with the 2012 federal budget, which introduced several new references to “series of transactions” in the Act.\footnote{Canada, Department of Finance, 2012 Budget, March 29, 2012. See supra note 4 for a list of some of the amendments included in the subsequent legislation.} And although the exercise of determining the purpose of the invocation of the series concept in an anti-avoidance provision will not be free of ambiguity and uncertainty, it will often be the correct inquiry for a court to be undertaking in determining whether a particular subset of transactions ought to be considered a series, given the context and the apparent animating purpose or purposes of a particular provision.

With respect to the second question—namely, having determined the purpose of the provision, how should a court use that purpose to determine whether or not a series exists? The answer in many statutory contexts is that the set of transactions must bear a family resemblance to those that Parliament could reasonably be considered to have had in mind in invoking the series concept as a means of anti-avoidance. Under a family resemblance approach to series of transactions, a court would begin by identifying a stylized set of transactions or events (generally an avoidance arrangement of some kind) that Parliament could reasonably be considered to have
had in mind in drafting the provision (or provisions) in which the series concept appears. The court would then attempt to ascertain whether the transactions carried out by the taxpayer bore a sufficient family resemblance to that stylized set of transactions or events to be considered a series for the purposes of that particular statutory invocation of the term.

The utility of the family resemblance approach to identifying whether a series of transactions exists in the context of a particular provision might be better appreciated by considering some examples. Consider the following example from the article by Brender cited earlier:

Bidco is a wholly owned subsidiary of a public corporation, Pubco. Bidco intends to acquire all of the shares of Target, also a public corporation, in an all-cash deal. Certain management employees of Target are specified shareholders for purposes of the bump denial rules in paragraph 88(1)(c). As part of a pre-sale reorganization, at the request of Bidco, Target carries out a “packaging” transaction pursuant to which certain assets are transferred on a tax-deferred basis to a newly formed subsidiary corporation of Target. Following the takeover, Bidco plans to wind up Target and bump the ACB [adjusted cost base] of the subsidiary to fair market value under paragraph 88(1)(c), and then sell the subsidiary to an arm’s-length third party. In connection with the takeover, Bidco will enter into employment agreements with the management employees of Target providing that those employees will receive, in accordance with Pubco’s regular compensation policy, options to acquire shares of Pubco. The purpose of the stock option grant is to retain Target’s management employees and foster their loyalty to Pubco following the takeover. Target’s management has no involvement in Bidco’s tax planning and is unaware that Bidco is contemplating a bump reorganization.87

The question in Brender’s example is whether the acquisition by the management employees of options or shares of Bidco forms part of the same series of transactions as the windup of Target, causing the bump denial rule in subparagraph 88(1)(c)(vi) to apply. Focusing only on the length of time between the transactions, or on whether the option grant would have occurred in the absence of the series that includes the sale and subsequent windup of Target (such that it could be said that the grant occurred “because of” the series), might lead one to conclude that the transactions would be characterized as forming a series; and yet, to many (including us), this would seem intuitively to be an inappropriate result. Brender argues that the transactions do not form a series because they do not share a common purpose, a point with which we agree. That being said, in our view, the option grant should not form part of the series for a more fundamental reason—namely, that the option grant does not bear any family resemblance to the types of transactions that Parliament can reasonably be considered to have had in mind when it enacted subparagraph 88(1)(c)(vi).

87 Brender, supra note 35, at 223.
Begin with the first part of the family resemblance test. What is the purpose of the provision that invokes the series of transactions concept—in this case, subparagraph 88(1)(c)(vi)? Because the Act is silent on the purpose, recourse must be had to commentary from the Department of Finance and various tax publications. Without going into exhaustive detail here, it appears to us from the literature that the widely accepted purpose of subparagraph 88(1)(c)(vi) is to prevent “back-door purchase butterflies.” In a typical back-door purchase butterfly, a taxpayer owns shares of a corporation ("Opco") and wants to sell one of its properties ("asset A") to a third-party purchaser and to keep the remainder of its assets. In order to avoid the corporate-level tax that would be payable if the taxpayer were to cause Opco to sell the property directly to the third party, Opco transfers all of its property other than asset A to a newly created subsidiary ("Subco") on a tax-deferred basis as part of a packaging transaction not unlike the one described in Brender’s example. The taxpayer sells the shares of Opco to the third-party purchaser, and the purchaser winds up Opco, bumping up the cost of its shares in Subco in the process. The purchaser then sells the Subco shares to the taxpayer, who is left in the same position that he would have been in if he had caused Opco to sell asset A directly to the purchaser.

The second part of the family resemblance test asks whether what occurred in Brender’s example bears any family resemblance to the sort of back-door purchase butterflies that the invocation of the series concept in subparagraph 88(1)(c)(vi) was aimed at. Simply put, in our view there is no subset of the sequence of events described in Brender’s example that bears a family resemblance to the avoidance arrangement that Parliament sought to address through the enactment of subparagraph 88(1)(c)(vi). It would therefore be inappropriate to describe any such subset of the transactions outlined as part of a series for the purposes of that provision.

The analytical importance of the family resemblance concept is even more apparent in cases where there is a common purpose underlying a sequence of transactions (such that one cannot avoid an inappropriate result simply by applying Brender’s purposive approach), but that shared purpose bears little or no relationship to the anti-avoidance purpose of the provision whose application is being considered.

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89 This example is taken directly from the technical notes to subparagraph 88(1)(c)(vi) issued at the time the provision was introduced: Canada, Department of Finance, Explanatory Notes Relating to Income Tax (Ottawa: Department of Finance, December 1997), at subclauses 118(3) and (4).
Consider the example of a corporation (“Xco”) that operates a division of its business (“division A”) through a wholly owned subsidiary (“Aco”). Xco would like to sell Aco in the medium term but believes that, in order to achieve an optimum selling price, it must further develop the business carried on by division A; however, it requires additional capital to do so. To that end, Xco attracts an arm’s-length investor (“Investco”). Investco subscribes for a minority stake in Aco in exchange for subscription proceeds that Aco uses to carry on the development work needed to put it on the market. Six months later, when the work has been completed, and in anticipation of the sale of Aco, Xco rolls its shares of Aco to a sister corporation with capital losses (“Lossco”) in exchange for preferred shares of Lossco. These preferred shares are then subsequently redeemed in exchange for a promissory note. As soon as a buyer is found, Lossco will sell the Aco shares and use its losses to offset the gain realized.

In this type of situation, the redemption of the preferred shares issued to Xco by Lossco will generally be regarded as leading to a deemed capital gain under subsection 55(2) unless one of the exemptions set out in paragraph 55(3)(a) or (b) applies. Xco will ideally be able to rely on paragraph 55(3)(a), on the basis that none of the triggering events described in that provision has occurred. Subparagraph 55(3)(a)(ii), however, provides that paragraph 55(3)(a) does not apply to a dividend if, as part of the same series of transactions as the dividend, there is a significant increase in the total direct interest of any unrelated person in any corporation. Thus, the question will be whether the subscription by Investco for shares of Aco six months prior to the redemption of the preferred shares issued by Lossco forms part of the same series as that redemption. If so, paragraph 55(3)(a) will not apply, and subsection 55(2) will deem a capital gain to be realized. The transactions will be relatively closely related in time. Moreover, depending on the circumstances, the redemption could be considered to be causally linked to the share subscription by Investco, and to have been more than a mere possibility at the time of that subscription. Finally, the transactions arguably share a common purpose, namely, facilitating the sale of Aco by Xco and its corporate group. It is difficult, however, to see how the application of subparagraph 55(3)(a)(ii) can be justified. How would the family resemblance test address this example?

Begin again with the first step of the test. What is the purpose of subsections 55(2) and (3)? These subsections are regarded in the tax community as being intended to counteract capital gains strips.90 Subparagraph 55(3)(a)(ii), in particular, seems to have been enacted for the purposes of avoiding a relatively straightforward avoidance technique: rolling an asset that the taxpayer intends to sell to a third party into a newly created subsidiary, having the third party subscribe for shares of the

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90 See, for example, Brian Robson, “Capital Gains Strips: A Tale of Small Details,” *CGA Magazine*, November 12, 2011 (http://cgamagazine.ca/capital-gains-strips/): “On the sale of a business, advisors routinely look to shield tax through capital gains strips and/or using capital gains exemptions. The relevant rules are set out in Section 55 of the *Income Tax Act*.”
subsidiary, and then having the subsidiary use the subscription proceeds to redeem the shares held by the taxpayer.91

With respect to the second part of the family resemblance test for series of transactions, it is safe to say that no subset of the transactions undertaken by Xco, Investco, and Lossco in the above example involves capital gains strips or bears any family resemblance to the type of planning that Parliament can reasonably be regarded as having had in mind when it enacted subparagraph 55(3)(a)(ii). This should be the most important factor in determining whether a series exists. Focusing on narrow questions of relatedness, such as the number of days elapsed between the transactions undertaken, is an inadequate alternative to the family resemblance test that we endorse. Obviously, looking at the time elapsed between transactions is apt to be both overinclusive and underinclusive. It would be overinclusive in that it would then apply to situations such as the example given above involving Investco. It would be underinclusive in that it would not apply to situations in which taxpayers have decided that “waiting it out,” while inconvenient, is worthwhile in order to secure a relevant tax benefit that would otherwise (rightly, in light of Parliament’s purpose) be denied to them.

We are aware that it might be objected that the family resemblance test that we propose does not attend sufficiently to the fact that subsection 248(10) defines “series of transactions” for the purposes of the entire Act. Indeed, Carr and Milot cite case law that explains that it is not appropriate to give the same term different meanings in different sections of the Act.92 We agree with the motivation underlying this principle in the case law, and recognize and acknowledge that it is a general presumption of statutory interpretation. We also bear in mind that it is merely one of many presumptions that courts use in the interpretive process, and that a large number of such presumptions are always simultaneously in play. Having recognized and acknowledged this, it would be a mistake to conclude that a family resemblance approach to the series concept offends the principle of consistency. Indeed, the term “series” would be given the same interpretation in each provision in which it is found for the simple reason that it would involve the same textual, contextual, and purposive interpretive exercise each time that it appears. More specifically, with respect to purpose, the question would be whether the transactions entered into bear a family resemblance to those that Parliament can reasonably be considered to have had in mind in referencing the concept in enacting the provision in issue. Put another way, the words “as part of a series of transactions” would be interpreted through the contextual and purposive lens in each case as though they read “as part of a sequence of transactions that bears a family resemblance to the ones Parliament intended” in the relevant rule. The inappropriate (and in some cases absurd) results that follow from demanding a perfectly consistent meaning of series of transactions

92 Carr and Milot, supra note 27, at 263.
throughout the Act suggests that a textual insistence on this presumption is inappropriate with respect to the series concept.

Another objection might reasonably be raised regarding series in the context of anti-avoidance standards (rather than rules). As we explain in the next section of the article, precisely the same family resemblance approach can be used in the GAAR context—though, as we will explain, the way that series is invoked in GAAR suggests a somewhat different contextual and purposive use of the family resemblance concept. In fact, in the GAAR context, the series concept is invoked in two different subsections, thereby necessitating a more considered treatment of what Parliament can be construed as having intended series to mean in its enactment of GAAR.

**The Family Resemblance Approach to “Series” in a GAAR Context**

In the case of GAAR, it is not possible to pinpoint ex ante a particular family of transactions that Parliament sought to address with the provision’s enactment. Thus, an important question that arises under the family resemblance approach is how it should be applied in the context of GAAR. Naturally, and as is well known, in the wake of the Supreme Court of Canada’s judgment in *Stubart Investments*,94 which rejected a judicial business purpose test, Parliament’s motivation in enacting GAAR was to combat tax avoidance in a general way, by avoiding having to clearly articulate with specificity in advance the particular types of transactions that would be denied a tax benefit that would otherwise be realized by the taxpayer, insofar as that tax benefit would be gained inappropriately through reliance on a distorted interpretation of one or more statutory provisions. Stepping in to perform this role in GAAR is the idea of the object, spirit, or purpose underlying one or more relevant legislative provisions under the misuse or abuse test in subsection 245(4). If there is no misuse or abuse under subsection 245(4), then the general rule in subsection 245(2) will not apply to deny the tax benefit realized by the taxpayer. It is curious, therefore, that subsection 245(4) does not make reference to the series concept at all. Instead, GAAR uses the series concept in two other places:

1. in the definition of “avoidance transaction” in paragraph 245(3)(b); and
2. in the articulation in subsection 245(2) of the principal rule that denies the taxpayer a tax benefit if GAAR applies.

The appropriateness of our approach to series in the non-GAAR context extends also to the series concept in the GAAR context, and we can use precisely the same family resemblance approach in addressing the contextual and purposive elements of the interpretation exercise. However, there is a significant difference between the

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94 *Stubart Investments Ltd. v. The Queen*, [1984] 1 SCR 536.
non-GAAR and the GAAR contexts for series. In the non-GAAR context, it is likely to be more straightforward to determine the purpose for the invocation of the series concept by Parliament. In the GAAR context, because it is a general rule (or, in other words, a standard), it will be often be somewhat less obvious what family of arrangements needs to be compared.

As noted above, the series concept is invoked in GAAR in paragraph 245(3)(b), with reference to whether the taxpayer has engaged in an “avoidance transaction,” and in subsection 245(2), with reference to the denial of a “tax benefit”\(^\text{95}\) that results from an “avoidance transaction” or from “a series of transactions that includes that [avoidance] transaction.” Subsection 245(2) further provides that the tax consequences will be determined “as is reasonable in the circumstances,” and subsection 245(4) requires, for the application of subsection 245(2), that the avoidance transaction results in a misuse or abuse of the relevant statute.

In interpreting the invocation of the series concept in paragraph 245(3)(b) and subsection 245(2), it is important (as in the non-GAAR context) to begin with the textual, contextual, and purposive analysis that applies to all questions of statutory interpretation. In both provisions, there is scope for the application of a family resemblance test to guide a court’s assessment of whether there was a series for the purposes of GAAR.

Clearly Parliament intended “series” to refer to the same broadened set of transactions in both paragraph 245(3)(b) and subsection 245(2). That is, the series reference in GAAR should be construed as denying a tax benefit where there is a set of transactions that simultaneously secures a tax benefit through a tax-motivated and interdependent sequence of transactions or events, and constitutes a misuse or abuse through a family resemblance to a stylized transaction that is abusive.

**“Series” in Paragraph 245(3)(b)**

Analytically, the entry point into GAAR for our purposes is subsection 245(3), the provision that defines the meaning of “avoidance transaction.” Subsection 245(3) reads as follows:

\(^{(3)}\) 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.

\(^{95}\) Subsection 245(1) defines “tax benefit” to mean “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.”
Pursuant to subsection 245(3), there are two ways in which a transaction can satisfy the statutory requirement for an “avoidance transaction.” The first, addressed by paragraph 245(3)(a), is that the transaction that is under scrutiny itself yields a tax benefit, and that transaction cannot reasonably be regarded as being motivated by some purpose other than obtaining the tax benefit. The second, addressed by paragraph 245(3)(b), expands on the first to sweep in any transaction that is part of a series that similarly yields a tax benefit and has one or more constituent transactions that cannot reasonably be regarded as being motivated by some purpose other than obtaining the tax benefit.

It is arguable that paragraph 245(3)(a) does not cast the anti-avoidance net very widely at all, since an attentive taxpayer could in many circumstances ensure that the transaction that ultimately triggers the realization of a tax benefit is separate from the transaction that was predominantly tax-motivated. This argument is weakened by two observations. First, the phrase “directly or indirectly” in paragraph 245(3)(a) suggests that a predominantly tax-motivated transaction that indirectly secures a tax benefit through a separate non-tax-motivated transaction can still be construed as an avoidance transaction. Second, a “transaction” is defined in subsection 245(1) to include “an arrangement or event.” Although “arrangement” is not itself a defined term in the Act, it is arguable that the ordinary meaning of “arrangement” embraces greater potential complexity than “transaction,” and, if this is correct, then the definition of “transaction” as including “an arrangement or event” is itself an expansion of what would otherwise constitute an avoidance transaction under paragraph 245(3)(a). Yet, even if it is acknowledged that paragraph 245(3)(a) may not be as narrow as it at first appears, paragraph 245(3)(b) is more expansive in its textual focus on multiple transactions.

This brings us to Parliament’s invocation of the series concept in paragraph 245(3)(b). Applying the family resemblance test, the first step is to ask what the context and purpose of paragraph 245(3)(b) tell us about the reason for the use of the series concept in this provision. It is natural to see paragraph 245(3)(b) as an attempt to expand the domain for finding that the taxpayer has engaged in an avoidance transaction. It identifies as an avoidance transaction any transaction that is part of a series of transactions that collectively—that is, as a series—results in a tax benefit, unless the particular transaction in question can reasonably be regarded as not being predominantly tax-motivated. Thus, the purpose of invoking series in paragraph 245(3)(b) is to expand the scope of the meaning of avoidance transaction from the focus of paragraph 245(3)(a) on a singular transaction to include any series that has at least one element (such as a transaction, an arrangement, or an event) that is predominantly motivated by securing a tax benefit. The implicit reasoning behind Parliament’s decision to adopt this formulation is clear enough. Just as “division by zero” at any stage of an algebraic manipulation renders an entire sequence of reasoning logically invalid and unreliable, so too should the injection of any predominantly tax-motivated element into a series of transactions render suspect the legitimacy of a tax benefit from an entire series of transactions. Thus, this first step of the family resemblance test for the invocation of the series concept in paragraph 245(3)(b) tells
us to focus on the desire of Parliament to capture all transactions that bear a certain relation to the generation of a tax benefit that, but for GAAR, would be realized by the taxpayer.

The second step of the family resemblance test for the use of series in paragraph 245(3)(b) requires us to ask what kinds of transactions Parliament would have wanted to include in the series given that the focus is on expanding the ambit of “avoidance transaction.” From this perspective, the focus should be on the relationship among and between a sequence of transactions or events insofar as they are linked to the generation of a tax benefit. Thus, at this stage of the analysis, the question is whether the transactions or events are sufficiently related to each other in the sense that they interdependently generate the tax benefit identified by the minister. If the transactions are interdependent in this way, then they should be regarded as a series for the purposes of paragraph 245(3)(b).

This conclusion echoes what has been suggested by early commentators on GAAR. For example, in 1997 Couzin addressed the difficulty of applying the series concept in the context of paragraph 245(3)(b). He stated:

I would not be surprised to find different judges reaching different conclusions as to how the series rule works. A literal approach could require that there be an identified transaction [in a purported series] that fails the purpose test. However, I could also imagine a more “purposive” interpretation of paragraph 245(3)(b) that reached the situation where the series as a whole reflected a primary tax motivation in the manner of its construction or shape, even though each step, standing alone, passed the purpose test.96

Although we hesitate to endorse Couzin’s imagined series under paragraph 245(3)(b), where each individual element satisfies the purpose test, we do endorse his view that Parliament’s intention was clearly to expand on the ability of paragraph 245(3)(a) to capture the pursuit of tax benefits by taxpayers through more than one transaction.

Another contextual point relates to the fact that the avoidance transaction test plays merely a gatekeeping function, being a step in the application of GAAR that precedes the determination of whether there has been a misuse or abuse under subsection 245(4) (discussed below). This could account for Couzin’s appreciation of a more purposive approach to the interpretation of series in paragraph 245(3)(b). It also suggests that as an analytical matter, there should be an inclination—at least in principle—to subject the entire series to further scrutiny under the remainder of GAAR. Another way of putting the same point is that in this context, where there is yet another stage of analysis that will determine whether the tax benefits are preserved or lost to the taxpayer (that is, whether there is a misuse or an abuse), it

would be sensible to attribute to Parliament a desire to be more inclusive rather than less inclusive with respect to what constitutes a series. Given that the concept of an avoidance transaction serves a gatekeeping function in GAAR—since without an avoidance transaction there can be no application of GAAR to deny a tax benefit—the degree of connection required among transactions in determining whether there has been a series under paragraph 245(3)(b) should not be overly demanding. Moreover, it is arguable that because the series concept is also invoked in GAAR in subsection 245(2), it would be inappropriate to be too hasty in concluding that a taxpayer does not have an avoidance transaction because the taxpayer does not have a series under paragraph 245(3)(b). Since it is likely that Parliament intended the reference to series to apply to the same set of transactions in the application of both paragraph 245(3)(b) and subsection 245(2), for analytical completeness one should conduct both exercises before determining whether there is a series.

To summarize, the purpose of paragraph 245(3)(b) is to expand the range of transactions that will be avoidance transactions to which GAAR might potentially apply. The reasons for Parliament’s invocation of the series concept in paragraph 245(3)(b) were (1) to avoid narrow and technical arguments from taxpayers about what constitutes a transaction, arrangement, or event (as opposed to a series); and (2) to reduce the scope for taxpayers to argue that a particular tax benefit did not “indirectly” result from a transaction, arrangement, or event (again, as opposed to a series) that was itself predominantly tax-motivated. Instead, Parliament’s focus in subsection 245(3) as disclosed by a textual, contextual, and purposive analysis relates to whether the taxpayer engaged in a sequence of transactions that in one or more respects was primarily tax-motivated. Put simply, if the minister is able to show that there was a predominantly tax-motivated element in a sequence of transactions then, as a preliminary matter (at least until one has conducted the exercise of interpreting “series” under subsection 245(2)), any interdependent aspect of the sequence of transactions leading up to and following the predominantly tax-motivated element should be considered to be part of the paragraph 245(3)(b) series.

“Series” in Subsection 245(2)

This brings us to the second invocation of the series concept in GAAR, found in subsection 245(2). This provision reads as follows:

(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.

Textually, subsection 245(2) requires the transaction at issue to be an “avoidance transaction.” As we have just explained, where there is a sequence of transactions that is also a series under paragraph 245(3)(b) and that series includes at least one predominantly tax-motivated element, this avoidance transaction requirement will (at least as a preliminary matter) be satisfied. One predominantly tax-motivated
element in an interdependent sequence of transactions will result in the characterization of all the transactions in that sequence as avoidance transactions, pursuant to our analysis of series in paragraph 245(3)(b).

Turning to the first part of the family resemblance test for the purposes of the use of the series concept in subsection 245(2), the question is this: On the basis of the text, context, and purpose of subsection 245(2), what is the role of the series concept in subsection 245(2)? The effect of subsection 245(2), when it applies, is to deny the taxpayer a “tax benefit” that the taxpayer would realize if GAAR did not apply. The tax benefit that the subsection denies is one that results directly or indirectly from the avoidance transaction itself (as determined under paragraph 245(3)(b)) or from “a series of transactions that includes that transaction.” As was the case with respect to the use of series in paragraph 245(3)(b), it appears from the context and purpose of the invocation of series in subsection 245(2) that Parliament’s intention is to expand considerably the range of transactions in respect of which tax benefits might be denied through the application of GAAR. This expansive intention is both reasonable and appropriate in light of the other safeguards that limit the deleterious effects that might otherwise be problematic. There are two safeguards that protect the interests of taxpayers from what might otherwise be overreaching by Parliament. The first safeguard is the requirement that whatever is done in denying a tax benefit must be “reasonable in the circumstances.” This standard allows for some flexibility; however, it is presumed that all the surrounding facts will be drawn upon in tailoring an appropriate remedy. The second safeguard is that for a tax benefit to be denied under subsection 245(2), the minister must show that what has been done is a misuse or abuse under subsection 245(4). Working together, these two safeguards justify the view that the purpose for Parliament’s invocation of series in subsection 245(2) was to reduce the scope for narrow and technical arguments about the boundaries of the transactions that should be subject to scrutiny and potential remediation under GAAR. This is similar, of course, to the anti-formalist motivations underlying the use by Parliament of the series concept more generally.

In order for GAAR to deny a tax benefit to a taxpayer under subsection 245(2), the minister must show that there has been a misuse or abuse under subsection 245(4). This provision reads as follows:

(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
The gist of the abuse analysis under subsections 245(2) and (4) consists of determining whether a particular transaction is the sort of transaction that Parliament would not have wanted taxpayers to engage in.97 According to the Supreme Court of Canada, such transactions include transactions that (1) rely on provisions to achieve an outcome that they were designed to prevent, (2) defeat the underlying rationale for provisions of the Act, or (3) circumvent provisions of the Act in a manner that defeats their object, spirit, or purpose.98 We contend that if a particular transaction in its context bears a family resemblance to a stylized transaction that is accepted as being abusive, then the safeguard of subsection 245(4) ought not to operate to protect the tax benefit claimed by the taxpayer, which will be denied “as is reasonable in the circumstances” by the operation of subsection 245(2).

Thus, our analysis of the text, context, and purpose of subsection 245(2) indicates that the intent in invoking the series concept in this provision is (1) to reduce the scope for taxpayers to legitimately argue that a particular tax benefit did not result in a sufficiently direct way from a tax-motivated element in a sequence of transactions (a role similar to the one that the concept plays in paragraph 245(3)(b) with respect to whether there is an avoidance transaction); and (2) to provide a court with a wide platform for denying a tax benefit under subsection 245(2) where an element in a sequence of transactions is appropriately regarded as abusive pursuant to subsection 245(4). Arguably, in light of the safeguards against applying GAAR to sequences of transactions that are not tax-motivated (the avoidance transaction requirement) and that are not abusive (subsection 245(4)), a sequence of transactions should be regarded as a series for the purposes of GAAR if those transactions interdependently give rise to a tax benefit identified by the minister. This expansive approach with respect to finding the existence of a series in the context of GAAR is particularly suitable in light of the additional safeguard that the Supreme Court has provided in insisting that the abusive nature of a transaction or series must be clear, and that the onus is on the minister to show that the taxpayer has engaged in a misuse or abuse.99

“Series” Analysis According to Family Resemblance in MIL and Copthorne

Our analysis of the two GAAR provisions that include a reference to series has led us to conclude that a sequence of transactions will be a series for the purposes of GAAR when one can say that the transactions in that sequence are interdependent in the

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98 Canada Trustco, supra note 6, at paragraph 45; Lipson v. Canada, 2009 SCC 1, at paragraph 25; and Copthorne, supra note 5, at paragraph 72.
99 Canada Trustco, supra note 6, at paragraphs 62 and 65.
sense that they give rise to the tax benefit challenged by the minister. How would this series analysis, which would require determining the sequence of transactions that includes the purportedly tax-motivated element as well as the abusive element, play itself out in the context of some well-known GAAR cases? To make the foregoing discussion of the series concept in the GAAR context more concrete, let us consider the facts of MIL and Copthorne.

The starting point of the series analysis in both cases is the identification of the tax benefit. As discussed earlier, the tax benefit in MIL was the treaty exemption under the Canada-Luxembourg tax treaty that the taxpayer claimed in respect of a significant capital gain on the sale of shares of DFr held by MIL. On the basis of the above analysis, what should the boundary of the series of transactions be for the purposes of paragraph 245(3)(b) and subsection 245(2)? With respect to paragraph 245(3)(b), any transaction in the sequence of transactions that preceded the purported treaty-exempt capital gain should be considered to be part of the series. Those transactions would include the continuation of MIL into Luxembourg, the disposition by MIL to Inco of the shares of DFr necessary to bring MIL’s interest below 10 percent, and the ultimate share sale realizing that capital gain. With respect to subsection 245(2), it is clear that the same boundaries are reasonable for the series, given the Crown’s contention that treaty shopping was the abusive element of the claimed tax benefit. Because the scope of the series issue in the GAAR context reduces to the set of transactions that interdependently gave rise to the claimed tax benefit, and moves away from the questions considered by the courts that we addressed earlier in this article, the series issue should be easier to decide. So long as the purported principally tax-motivated transaction and the purported abusive transaction are linked to the realization of the tax benefit, in the sense that the tax benefit depends for its existence on the tax-motivated transaction under paragraph 245(3)(b) and likewise on the purported abusive transaction under subsection 245(2), the series determination should not be a challenge. In MIL, even setting aside the fact that GAAR at the time did not mention tax treaties (and only did so with the retroactive amendment of GAAR in 2005), the challenging aspect of the case for the Crown would be to demonstrate that treaty shopping generally is a misuse or abuse. As mentioned earlier, the minister has the onus of demonstrating that the treaty shopping engaged in by the taxpayer should be considered to be a misuse or abuse.

Does this same kind of analysis extend to Copthorne? As described at the beginning of this article, the tax benefit in Copthorne related to the claimed return of capital in conjunction with the 1995 redemption. The return of capital relied on the PUC of the redeemed shares, which included PUC linked to the 1993 share sale. On the facts of the case, it is clear to us that the series of transactions for the purposes of GAAR should encompass both the transaction that was the predominantly tax-motivated transaction pursuant to paragraph 245(3)(b)—the 1993 share sale—and the transaction purportedly giving rise to the abuse under subsections 245(2) and (4)—the horizontal amalgamation and the consequent duplication of the PUC long before the 1995 redemption. Since both of these transactions are, as a preliminary determination, construed as being part of the series for the purposes of both paragraph 245(3)(b)
and subsection 245(2), they can then fairly be subjected to a misuse or abuse analysis under subsection 245(4).

In our view, if in Copthorne the Supreme Court had approached the series issue from the family resemblance perspective, the determination of whether there had been a series of transactions would have been considerably simplified and would have borrowed strength from the analysis conducted by the court at paragraphs 68 through 122 of its judgment.100 The court would have first attended to the object, spirit, and purpose of the provisions cited by the Crown, bearing in mind the allegedly abusive tax result realized by the taxpayer. Only when the court was clear on this question would it have turned to the issue of whether the transactions engaged in by the taxpayer could reasonably be said to bear a family resemblance to the kinds of PUC-duplicating transactions that would offend the object, spirit, and purpose of the Act.

POSSIBLE STATUTORY AMENDMENTS TO PROMOTE PREDICTABILITY, CERTAINTY, AND FAIRNESS

Given the path that Canadian tax law has taken with respect to the series concept, it is arguable that the best path forward is one that consciously and explicitly resets the approach. There are several ways in which the approach could be reset explicitly by a legislative amendment, and some design choices would have to be made in the process.

The first possibility would be to replace the series concept with something else entirely throughout the Act. Given that the series concept is now invoked in many anti-avoidance contexts in the Act, and in light of the general reluctance to make sweeping changes to the Act without being able to anticipate fully all of the consequences (particularly in this case, owing to the prevalence of the series concept), it is probably unrealistic to suggest that the series concept could be jettisoned altogether. Nevertheless, if this were possible, the concept could be replaced with something along the lines of an open-ended and loose definition of an “arrangement” (discussed below, though only in the GAAR context) coupled with a required purposive element similar to the family resemblance test that we propose in this article. It would then presumably be necessary (or at least prudent) to specify within each provision that referenced the new concept (or in the regulations relating thereto) the types (or families) of transactions to which the anti-avoidance rule was intended to apply. The advantage of sweeping amendments of this kind is that they would make manifest the intention of law makers in curbing particular types or families of tax avoidance, and at the same time would avoid disputes over prior case law and the correct interpretation of subsection 248(10).

In the event that moving away from the series concept entirely should prove to be beyond law makers’ appetite for reform, in our view the next-best option would be

100 See Copthorne, supra note 5.
to amend subsection 248(10) to explicitly instruct judges to take into account the types or families of transactions that Parliament can reasonably be considered to have wanted to address in invoking the series concept. For the reasons outlined above, this approach would naturally work best for the use of the series concept in a non-GAAR context. In the GAAR context, it might be wise to consider doing away with the series concept altogether and replace it with a low threshold test along the lines of the one conceived of by Rothstein JA in *OSFC*. Rothstein JA remarked that a possible understanding of the series concept would be that of “mutual interdependence.”101 One formulation of a mutual interdependence test for series states that “two or more transactions will constitute a series if the transactions are so interdependent that the legal relations created by one transaction would be meaningless without a completion of the series.”102 Despite referring to this possibility of embracing a low threshold for series, Rothstein JA did not do so in *OSFC*.

With respect to perhaps hiving off the GAAR context for different treatment from the specific anti-avoidance concepts that also make use of the series concept, it is instructive that the United Kingdom has decided not to use the series concept in its new general anti-abuse rule (“UK GAAR”). Instead, it has adopted a “tax arrangement” test, which sets a low threshold for determining whether transactions are tax-motivated. According to the most recent guidance from HM Revenue & Customs, under the new UK GAAR,

> [i]n broad terms a tax arrangement is any arrangement which, viewed objectively, has the obtaining of a tax advantage as its main purpose or one of its main purposes.103

The guidance goes on to explain that

> the broad definitions of “arrangements” and “tax arrangements” set a low threshold for initially considering the possible application of the GAAR. A much higher threshold is then set by confining the application of the GAAR to tax arrangements which are “abusive.”104

Given that the United Kingdom has had the benefit of surveying the international experience with general anti-avoidance rules, it is quite illuminating that it has decided to adopt an approach that bears greater resemblance to the New Zealand example than to the Canadian approach of invoking the series concept.

Another possible reform, and one that is less reliable and more likely to embroil Canadian courts in difficult debates about the state of law surrounding the series

\[101\] *OSFC*, supra note 11, at paragraph 21.

\[102\] Ibid.


\[104\] Ibid., at 10.
concept, is for judges to forge ahead in the absence of explicit guidance from law makers. This is distinctly a third-best option, but it is one that is defensible in light of the serious difficulties that the courts have had to date in settling on a consistent and reliable approach to the series concept. In conducting a textual, contextual, and purposive interpretation of the Act, we believe that judges in many circumstances would be able to make use of the family resemblance concept as we have outlined it above. As mentioned, however, we regard this ability to have recourse to the family resemblance concept through the conventional tools of statutory interpretation as an approach that is more difficult for the judiciary to apply. Nevertheless, a statutory amendment may not be forthcoming. Canadian judges are talented and resourceful. When faced with an incoherent and inconsistent concept and little or no guidance from law makers, they could certainly do worse than to find and take the path to conceptual coherence on their own.

CONCLUSION

While the Supreme Court’s decision in Copthorne arguably contains the most extensive treatment of the series concept by the court to date, there are still a number of areas of uncertainty. Copthorne effectively establishes a range for the threshold level of connection for a related transaction to be deemed to be part of a series requiring something more than a mere possibility but less than a strong nexus. The aim here has been to review the major issues canvassed in Copthorne and to suggest a new framework for understanding series based on a family resemblance test. The family resemblance test starts with a purposive analysis of each of the provisions that contains a reference to a series of transactions, to determine what type (or types, in the case of GAAR) of series of transactions Parliament can reasonably be considered to have been trying to address. In the context of GAAR, the types of series of transactions that Parliament can reasonably be considered to have been trying to address were those that secure a tax benefit through at least one predominantly tax-motivated transaction under paragraph 245(3)(b) where the tax benefit results from what purportedly amounts to abusive tax avoidance under subsections 245(2) and (4). Once the purpose of the applicable provision is determined and the prototypical series is specified, courts can consider whether the set of transactions before them sufficiently resembles that prototypical series to be captured by the rule.

The family resemblance approach that we have described would avoid many of the problems identified by commentators regarding the possible overbreadth of the Copthorne test for series when applied to other provisions of the Act. Indeed, one of the main criticisms of the Copthorne decision is that retrospective contemplation can be overly broad, particularly when applied in other contexts in the Act. If each provision is interpreted first to determine the purpose of its invocation of the series concept, this issue also can be avoided. We have shown that this approach works well even with GAAR, by recognizing that the misuse and abuse analysis plays a purposive role in that context similar to that which is naturally available in more contextualized statutory specific anti-avoidance rules. As mentioned in the introduction to this
In our view, family resemblance gives appropriate weight to all elements of the statutory interpretation exercise, being textual, contextual, and purposive, and it does so in a way designed to promote certainty, predictability, and fairness. Indeed, the family resemblance test should help to generate results that are more consistent with each of the provisions of the Act in which a series of transactions can play a role, by grounding the interpretation of those provisions in a purposive analysis. And by moving away from a narrow test focused on the connections between each individual event, the series test can be reformulated on the basis of the purpose of each provision, to suit the specific type(s) of transactions that the particular provision was designed to prevent.

It is probably impossible to definitively exhaust the meaning of “series.” Indeed, it is clear that much of the meaning must be drawn from the context in which the term is used, and the purpose for its invocation. Largely for this reason, to adopt any interpretive approach that is less than the family resemblance test described above will be to invite the problems that Wittgenstein described so clearly with respect to isolating the common features of games. Just like a game, any particular feature of a series is not always a feature of a series; indeed, in a comparison of two series, “you find many correspondences,” and yet in a third, “many common features drop out and others appear.”106 And when the context changes again, “much that is common is retained, but much is lost.”107 Wittgenstein would probably have appreciated the observation that a family resemblance analysis suggests that tax avoidance can reasonably be regarded as a game in its own right.

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105 See supra note 4.
106 Wittgenstein, supra note 78, at paragraph 66, quoted in the text above at note 79.
107 Ibid.
Policy Forum: Editor’s Introduction—
The General Anti-Avoidance Rule at 25

Last year marked the 25th anniversary of the enactment of the general anti-avoidance rule (GAAR) in section 245 of the Income Tax Act.\(^1\) As an apparent response to a perceived reluctance of the Canadian judiciary to articulate robust anti-avoidance doctrines, the introduction of GAAR provoked considerable reaction in the Canadian tax community. It is probably accurate to suggest that GAAR has altered the contours of tax planning in Canada. That altered landscape may be attributable in part to the fact that the jurisprudence considering the interpretation and application of this provision does not readily yield an especially clear road map, at least in the sense of providing certainty and predictability of result. Although there are a handful of cases that turn on the critical concepts of a tax benefit and an avoidance transaction, the more problematic feature of GAAR remains the requirement in subsection 245(4) that an avoidance transaction constitute a misuse of the provisions of the Act or an abuse of the provisions of the Act read as a whole; it is, of course, only such avoidance transactions that are subject to a denial of the tax benefit that would otherwise be available. Confusion over the precise contours of this necessary characterization as an outcome of an exercise in statutory interpretation appears to remain despite what is now a deep body of case law, including the considered opinion of the Supreme Court of Canada on four different occasions.

Given the lack of clarity in the interpretation and application of GAAR, it is hardly a surprise that there is no shortage of literature analyzing the case law generally and the Supreme Court of Canada’s decisions in particular. Nonetheless, we thought that the 25th anniversary of the enactment of GAAR provided a convenient opportunity to reflect further on what, if anything, we have learned from the jurisprudence. To that end, we invited a Canadian tax commentator and two Canadian tax practitioners to provide their thoughts on the state of the GAAR jurisprudence. We also invited a legal academic from New Zealand to comment on a recent line of cases considering a similar provision in the income tax legislation of that country. That case law is quite extraordinary for the radical change in the judicial attitude to tax avoidance that it reflects, and we think it provides a striking contrast in approach to that of Canadian courts.

In the first article that follows, Brian Arnold examines the development of the Supreme Court of Canada’s approach to the concept of abuse in subsection 245(4)

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\(^1\) RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this introduction are to the Act.
and considers where that approach is likely to lead. He suggests that, with the elevation of Rothstein J to the Supreme Court, there has been a subtle but significant shift in approach involving two important propositions: (1) that subsection 245(4) is an interpretive provision, not a substantive rule; and (2) that the determination of purpose is an interpretive exercise based on a textual, contextual, and purposive analysis of the relevant provisions implicated by an avoidance transaction. Arnold emphasizes that this exercise in statutory interpretation invariably requires a court to go beyond the words of such provisions in order for GAAR to have any meaning. He concludes, however, that the Supreme Court fails to articulate any kind of objective test or tests for the determination of abuse that can be applied with some degree of certainty.

In the second article, Alan Schwartz and Kevin Yip focus on the lessons of eight years of GAAR jurisprudence following the first two Supreme Court decisions. These lessons are framed from the important perspective of a tax practitioner defending against a GAAR assessment. Schwartz and Yip discuss both evidentiary issues and substantive issues related to the application of GAAR. Not surprisingly, much of their discussion concerns the exercise in statutory interpretation implicated by subsection 245(4). But they also make the notable point that tax practitioners should not concede too readily the existence of a tax benefit or the characterization of a transaction as an avoidance transaction. Indeed, Schwartz and Yip suggest that these two issues will be an area of increased dispute resolution, although the principal area of contentiousness will remain proof of the policies underlying relevant provisions in the context of a misuse or abuse inquiry.

In the third article, Craig Elliffe analyzes the recent GAAR jurisprudence in New Zealand. Despite the absence of a misuse or abuse requirement in New Zealand’s GAAR comparable to that in subsection 245(4) of the Act, NZ courts have interpreted that country’s GAAR to require a purposive exercise in statutory interpretation before a tax benefit provided by a tax-avoidance transaction can be denied. As Elliffe argues, NZ courts have read in this statutory overlay in an effort to narrow the application of what is perceived to be an overly broad prohibition on tax planning. A recent line of cases has significantly expanded such application, however, by emphasizing the legislative purpose of New Zealand’s GAAR itself and, most importantly, the relevance of “commercial and economic realities” in drawing the line between acceptable and abusive tax avoidance as an outcome of an exercise in statutory interpretation. It is not too difficult to imagine the kind of shock waves that would be felt in the Canadian tax community if our courts suddenly changed their attitude to the interpretation and application of section 245 in a manner similar to that evident in the recent GAAR case law in New Zealand.

Tim Edgar
Editor
Policy Forum: Some Thoughts on the Supreme Court’s Approach to the Determination of Abuse Under the General Anti-Avoidance Rule

Brian J. Arnold*

**KEYWORDS:** GENERAL ANTI-AVOIDANCE RULE ■ GAAR ■ STATUTORY INTERPRETATION ■ ABUSES ■ SUPREME COURT DECISIONS

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**INTRODUCTION: THE ISSUE**

Neil Brooks has written that “[Canada’s] income tax laws are a mess” and our judges are to blame: “Generally, judges have simply done an abysmal job of interpreting tax legislation.”1 Brooks’s view is that a judge’s “responsibility is to give a meaning to the statutory language that will lead to the most sensible tax policy result.”2 If judges

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* Senior adviser, Canadian Tax Foundation, Toronto (e-mail: barnold@execulink.com). An earlier version of this article was prepared for Osgoode Hall Law School, Tax Policy for a Better Tomorrow: Intersectoral and Multidisciplinary Connections, A Workshop in Honour of Neil Brooks, May 10-11, 2013 (Toronto: Osgoode Hall Law School, 2013).


2 Ibid., at 94.
behaved as he thinks they should, there would be no need for a general anti-avoidance rule (GAAR). However, the reality is that, despite Brooks’s best efforts, Canadian judges continue to see their role as a narrow one of interpreting and applying the law; they deny that they have any role in making law, which is the exclusive responsibility of Parliament. In this context, a GAAR is necessary, and given the broad nature of the Canadian GAAR,³ the courts are effectively forced into performing a law-making function.

This brief article deals with the issue of statutory interpretation and tax avoidance in the context of the concept of abuse in Canada’s GAAR—specifically, subsection 245(4).

The jurisprudence indicates that the application of GAAR requires three conditions to be satisfied: there must be

1. a “tax benefit,”
2. an “avoidance transaction,” and
3. a “misuse” of the provisions of the Act or an “abuse” of the provisions of the Act read as a whole.

A tax benefit is broadly defined to be any reduction, deferral, or avoidance of tax or other amount payable under the Act.⁴ An avoidance transaction is a transaction that results in a tax benefit or a transaction that is part of a series of transactions that results in a tax benefit, unless it can reasonably be considered that the primary purpose of the transaction was other than to obtain the tax benefit.⁵ In most of the GAAR cases that have been heard by the courts, the existence of a tax benefit and an avoidance transaction is usually clear; often, in fact, these aspects of GAAR are conceded by the taxpayer. Accordingly, in most GAAR cases, the crucial issue is the concept of misuse or abuse under subsection 245(4).

Under subsection 245(4), GAAR does not apply unless an avoidance transaction results in a misuse of the provisions of the Act (or the provisions of the regulations and rules thereunder, or of a tax treaty or other enactment) or an abuse of those provisions read as a whole. The Supreme Court of Canada has clearly established that there is no meaningful distinction between the concepts of misuse and abuse under GAAR.⁶ Moreover, the Supreme Court has held that subsection 245(4) is an interpretive

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³ Canada’s general anti-avoidance rule is contained in section 245 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

⁴ Subsection 245(1), the definition of “tax benefit.”

⁵ Subsection 245(3), defining “avoidance transaction.”

⁶ Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54, at paragraph 39: “Parliament could not have intended this two-step approach, which on its face raises the impossible question of how one can abuse the Act as a whole without misusing any of its provisions.” In my view, the Supreme Court is incorrect on this point. If a transaction has been designed so that a specific
test, not a substantive rule. In other words, whether an avoidance transaction constitutes an abuse involves a determination of whether the transaction is consistent with or violates the object and purpose of the relevant provisions of the Act.

This article analyzes how the Supreme Court’s approach to the concept of abuse under subsection 245(4) has developed and where that approach is likely to lead. The analysis presented here is not intended to be comprehensive or exhaustive. It does not deal with important aspects of the concept of abuse, such as the relevance of artificiality and economic substance; it is selective in terms of the cases that are examined, and it does not review in detail the factual context of those cases. Rather, this article presents my ideas about the Supreme Court’s view of the role of subsection 245(4) in the abstract.7

THE PURPOSE OF SUBSECTION 245(4)

Subsection 245(4) is intended to restrict or provide a safety valve against an overly broad application of GAAR. Parliament clearly intended that not all transactions whose primary purpose is to avoid or reduce tax should be considered offensive and rendered ineffective for income tax purposes. Accordingly, after casting the net of GAAR broadly in terms of the definitions of tax benefit and avoidance transaction, Parliament added an exception for avoidance transactions that do not contravene, frustrate, violate, conflict with, or abuse the purpose or policy of the Act.8

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8 Such an exception is common in statutory GAARs and is also found in the general test for the abuse of tax treaties. See paragraph 9.5 of the commentary on article 1 of Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital: Condensed Version (Paris: OECD, July 2010); and paragraph 23 of the commentary on article 1 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries (New York: United Nations, 2011), which quotes paragraph 9.5 of the commentary on article 1 of the OECD model convention.
RELEVANT CASE LAW

OSFC Holdings

The starting point for my analysis is the Federal Court of Appeal’s decision in the OSFC Holdings case.9 I have chosen that case as my starting point because until the first Supreme Court GAAR cases, OSFC Holdings was the leading GAAR case and, more importantly, the decision was written by Rothstein J, who has since been elevated to the Supreme Court.

In OSFC Holdings, Rothstein J adopted a two-stage test, first “identifying the relevant policy of the provisions of the Act as a whole” and then assessing the facts to determine “whether the avoidance transaction constituted a misuse or abuse having regard to the identified policy.”10 The first stage is “a question of interpretation.”11 Rothstein J made it clear that he used the term “policy” to refer collectively to the various descriptions of the approach to the determination of misuse or abuse as “purposive, object and spirit, scheme or policy.”12 Moreover, he stated, the determination of the policy of the Act is not limited to a consideration of the words of the relevant provisions or the Act as a whole, since that would render GAAR meaningless; rather, reference may also be made to “extrinsic aids such as technical notes, writings, Hansard and enacting notes.”13

Because an avoidance transaction will always comply with the letter of the relevant provisions,14 according to Rothstein J, the misuse or abuse analysis under subsection 245(4)

is not an exercise of trying to divine Parliament’s intention by using a purposive analysis where the words used in a statute are ambiguous. Rather, it is an invoking of a policy to override the words Parliament has used.15

Elsewhere in his reasons, he refers to “the policy behind” the relevant provisions.16 Although “strict compliance with the Act” is

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9 OSFC Holdings Ltd. v. Canada, 2001 FCA 260.
10 Ibid., at paragraph 67.
11 Ibid., at paragraph 68.
12 Ibid., at paragraph 66.
13 Ibid., at paragraph 63.
14 If a transaction does not comply with the provisions relied on for the tax benefit, GAAR, as a provision of last resort, is irrelevant and unnecessary.
15 OSFC Holdings, supra note 9, at paragraph 69.
16 Ibid., at paragraph 61. As noted below, Rothstein J returned to this terminology when he wrote the decision on behalf of the Supreme Court in the Copthorne case, infra note 27; see infra note 30 and the accompanying text.
normally . . . sufficient . . . Parliament has enacted subsection 245(4) and if any meaning is to be given to it, it must be to override the results of strict compliance when abuse of the provisions of the Act, read as a whole, is apparent.17

Rothstein J describes the court’s task to find an overriding policy under subsection 245(4) as an “unusual duty”18 and uses this to justify his conclusion that the policy must be clear and unambiguous; otherwise, GAAR cannot be applied.

Applying his two-stage approach, Rothstein J had “no difficulty concluding that the general policy of the Income Tax Act is against the trading of non-capital losses by corporations, subject to specific limited circumstances,”19 and that the transactions at issue contravened that clear policy.

**Canada Trustco and Mathew**

The first two GAAR cases heard by the Supreme Court were argued and decided together. *Canada Trustco*20 involved a prepaid lease arrangement under which Canada Trustco effectively purchased capital cost allowance to reduce its taxable income. The companion case, *Mathew*,21 was an appeal of the *OSFC Holdings* decision with a different lead taxpayer. The Supreme Court held that GAAR applied in *Mathew* but not in *Canada Trustco*, upholding the decisions of the Federal Court of Appeal in both instances. Of the two decisions, *Canada Trustco* is the leading one; in it, the Supreme Court sets out in detail its approach to the interpretation and application of GAAR. My focus here is the Supreme Court’s approach to the concept of abuse in subsection 245(4).

In *Canada Trustco* and *Mathew*, the Supreme Court rejected Rothstein J’s approach to establishing a misuse or an abuse, which involved a narrow textual analysis of the relevant provisions followed by a broad purposive analysis of the Act as a whole. Instead, the Supreme Court adopted what it described as “a unified, textual, contextual, and purposive approach.”22 The court’s use of the term “unified” in this

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17 *OSFC Holdings*, supra note 9, at paragraph 117.
18 Ibid., at paragraph 69. In a panel discussion at a Canadian Tax Foundation conference in 2005, Rothstein J reiterated this description of the court’s task in respect of GAAR: “So we are being asked, notwithstanding compliance, whether there is a misuse or an abuse. That’s different from our usual statutory interpretation exercise.” Rothstein J also suggested that the courts should be cautious in carrying out the “unusual duty” imposed by GAAR because it is difficult for a court to foresee the unintended consequences of its decisions. Brian Arnold, Judith Freedman, Al Meghji, Mark Meredith, and Hon. Marshall Rothstein, “The Future of GAAR,” in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 4:1-16, at 4:3-4.
19 *OSFC Holdings*, supra note 9, at paragraph 98.
20 *Canada Trustco*, supra note 6.
22 *Canada Trustco*, supra note 6, at paragraph 40.
context is confusing, but presumably means that there is no distinction between misuse and abuse. The court rejected Rothstein J’s comments about overriding policy in strong terms:

The courts cannot search for an overriding policy of the Act that is not based on a unified textual, contextual and purposive interpretation of the specific provisions at issue. . . . To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. . . .

[T]o search for an overriding policy of the *Income Tax Act* that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit would run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs.23

It is important to recognize that the court does not prohibit entirely a search for an overriding policy, but only a search for such a policy that is “not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit.” It is hard for me to imagine a Canadian court invoking policy to interpret the words of any statute if the policy was not derived from or based on those words. Certainly, in *OSF Holdings* Rothstein J did not suggest any such frivolity.

Despite rejecting Rothstein J’s comments about policy, the Supreme Court accepted, without any acknowledgment, the two-stage approach to the determination of abuse adopted in *OSF Holdings*. However, the court restricted the first stage to the determination of the purpose of the provisions that conferred the tax benefit, whereas Rothstein J referred to the determination of the policy of the provisions of the Act as a whole. Rothstein J’s approach is preferable to the Supreme Court’s in this regard. The Supreme Court’s focus on only the provisions relied on by the taxpayer for the tax benefit is too narrow. In many, if not most, cases, the tax benefit may be based on a single provision, but it will be necessary to examine several statutory provisions to determine the statutory scheme and the underlying rationale for that scheme.24

In *Mathew*, the Supreme Court decided that GAAR applied because “it is implicit that the rules [in subsection 96(1)] are applied when partners in a partnership carry on a business in common, in a non-arm’s length relationship.”25 Arguably, the court did precisely what it said was unacceptable: invoke an overarching policy that cannot be found in the text of the relevant provision. There is no suggestion in the

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23 Ibid., at paragraphs 41-42.
24 As a result, as Darmo and Fournier suggest (supra note 7, at 37:3), lower courts were reluctant to find abuse on the basis of the provisions of the Act read as a whole.
25 *Mathew*, supra note 21, at paragraph 51.
words of subsection 96(1) that the provision is limited to partnerships in which the relationship between the partners is non-arm’s-length.

Lipson

In 2006, the plot thickened: Rothstein J, the judge who had written what was recognized as the leading GAAR decision—until the Supreme Court rejected it—was appointed to that court. Since then, Rothstein J has become known as the Supreme Court justice who is most knowledgeable about and interested in tax issues. Two questions come to mind: How has the Supreme Court’s GAAR jurisprudence developed with Rothstein J playing a leading role on the court, and how will it develop in the future?

Rothstein J’s first GAAR case at the Supreme Court—Lipson—provides little detailed information about the court’s approach to GAAR, although it is clear that its attitude had shifted significantly in the four years since Canada Trustco and Mathew. The change in the composition of the court during those years produced a serious split concerning GAAR. In Lipson, a case involving an arrangement to obtain interest deductibility through the use of the spousal attribution rules, Binnie J, writing for the minority, disagreed sharply and openly with LeBel J, writing for the majority. Such open disagreements between justices of the Supreme Court are rare. The disagreement in Lipson is perhaps the more surprising in light of the fact that the decisions in Canada Trustco and Mathew were unanimous. If the Lipson decision reveals little about the Supreme Court’s approach to the interpretation of subsection 245(4), it reveals even less about Rothstein J’s view, because he took the position that the application of GAAR was unnecessary in light of subsection 74.5(11).

Copthorne

The decision in Copthorne, issued in 2011, indicates that Lipson was only a way station in the evolution of the Supreme Court’s approach to subsection 245(4). Rothstein J wrote the decision for a unanimous court and was instrumental in effecting that shift. My thesis is that under his influence the Supreme Court has moved away from the approach adopted in Canada Trustco, back to the approach adopted by the Federal Court of Appeal in OSFC Holdings.

In Copthorne, a parent and subsidiary corporations in the same corporate group became sister corporations before being amalgamated. If the parent and subsidiary corporations had been amalgamated without first becoming sister corporations, the paid-up capital of the shares of the subsidiary would have been eliminated on the amalgamation. Therefore, the effect of the preliminary step was to arbitrarily increase or duplicate the paid-up capital of the amalgamated corporation by the amount of the paid-up capital of the subsidiary.

27 Copthorne Holdings Ltd. v. Canada, 2011 SCC 63.
The taxpayer argued that the conclusion that the Act precluded corporations from preserving paid-up capital on amalgamation could be based only on a general policy against surplus stripping, contrary to the Supreme Court’s injunction in Canada Trustco against a search for an overriding policy.28 The Supreme Court rejected this argument on the ground that its decision was based on an analysis of the paid-up capital provisions, not “some broad statement of policy.”29 Thus, it appears that the injunction against invoking an overriding policy is not a serious constraint on the application of GAAR as long as the Crown can establish to the court’s satisfaction that the policy is grounded in a textual, contextual, and purposive analysis of the provisions of the Act.

What is more significant to me is how Rothstein J described the interpretive approach required for a determination of abuse under subsection 245(4). He began by saying that courts have “the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer.”30 GAAR deals with transactions that are “in strict compliance with the text” of the Act but are not necessarily in accordance “with their object, spirit or purpose.”31 Object, spirit, and purpose are what Rothstein J appropriately referred to in OSFC Holdings as “policy.”32 However, in Canada Trustco the Supreme Court expressed aversion to the use of this term. Perhaps this is because the Supreme Court has consistently rejected the idea of courts deciding cases on the basis of unexpressed notions of policy. Since the Friesen case in 1995,33 the Supreme Court has cited the following statement of principle, originally written by Peter Hogg and subsequently reiterated by Hogg, Magee, and Li:

It would introduce intolerable uncertainty into the Income Tax Act if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court’s view of the object and purpose of the provision.34

This is not the place for a detailed critique of the Supreme Court’s endorsement of this bit of indefensible hyperbole.35 The important point here is that in Copthorne

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28 Ibid., at paragraph 117.
29 Ibid., at paragraph 118.
30 Ibid., at paragraph 66.
31 Ibid.
32 OSFC Holdings, supra note 9, at paragraph 66.
34 Peter W. Hogg, Notes on Income Tax, 3d ed. (Toronto: Carswell, 1994), at 22:12, currently found in Peter W. Hogg, Joanne E. Magee, and Jinyan Li, Principles of Canadian Income Tax Law, 7th ed. (Toronto: Carswell, 2010), at 584. The same wording is used in the current version except that the word “routinely” has been inserted before “qualified.”
35 I have railed against this statement previously. Policy is always unexpressed in tax legislation; it must be inferred from the words of the legislation and from extrinsic aids. However, this is no
Rothstein J refers to object, spirit, and purpose not as policy, but (quoting Vern Krishna) as the “legislative rationale that underlies specific or interrelated provisions of the Act.” Later, he refers to the “underlying rationale” of the paid-up capital provisions.

**THE SUPREME COURT’S CURRENT VIEW OF THE CONCEPT OF ABUSE**

It is appropriate to pause here briefly to focus on the language used by the Supreme Court in describing the task of a court in applying subsection 245(4). The courts cannot search for an overarching or overriding policy—at least not one that is not based on a textual, contextual, and purposive analysis of the relevant provisions of the Act. In short, the policy must be attached to or anchored in the words in some fashion. As noted above, it is difficult to imagine a court inventing a tax policy that was not based on the legislation at all. This would be a violation of the judicial function and the rule of law. Unfortunately, some lower courts have misunderstood the Supreme Court’s caution about searching for an overriding policy that is not grounded in the provisions of the Act and have simply refused to look for any overriding or overarching policy.

Although the courts cannot search for an overriding or overarching policy, according to the Supreme Court, they can go behind or beneath the words to find the object and spirit or underlying rationale of the relevant provisions. When the Supreme Court refers to the underlying rationale, it does not emphasize that the rationale or policy must be based in some fashion on the words of the provisions. However, such a condition must be implicit. On a metaphorical level, I understand that the term “underlying rationale” involves connotations of foundations and bedrock—something solid—whereas “overarching or overriding policy” suggests something ethereal and insubstantial—not something that judges searching for certainty, predictability, and fairness would rely on. In substance, however, there is no difference between an overriding or overarching policy and an underlying rationale, despite the Supreme Court’s comments to the contrary. Both the underlying rationale and the overriding or overarching policy of the relevant provisions of the Act must be found by means of a rigorous analysis of the provisions of the Act as a whole and any relevant extrinsic aids.

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37 Copthorne, supra note 27, at paragraphs 87 and 109.
As I have suggested above, a close reading of *Copthorne* indicates that Rothstein J is moving the Supreme Court from its approach to GAAR in *Canada Trustco* back to his approach in *OSFC Holdings*.

First, although this is a small point, the introductory paragraphs of the decisions in *OSFC Holdings* and *Copthorne* are almost identical:

It is relatively straightforward to set out the GAAR scheme. It is much more difficult to apply it. Generally, where a transaction is an avoidance transaction (a transaction that would result in a tax benefit, and whose primary purpose was to obtain the tax benefit), the tax benefit resulting from the transaction will be denied. However, the tax benefit will not be denied if the avoidance transaction would not result in a misuse of the provisions of the Act or an abuse of the Act read as a whole [*OSFC Holdings*].

The differences in wording between these two passages are insignificant. The similarity in wording is telling because it suggests that, when Rothstein J wrote his reasons for judgment in *Copthorne*, he likely went back and consulted his Federal Court of Appeal decision in *OSFC Holdings*.

In addition, in both cases Rothstein J referred to the “unusual duty” imposed on a court under subsection 245(4):

The Court will proceed cautiously in carrying out the unusual duty imposed upon it under subsection 245(4) [*OSFC Holdings*].

And:

The GAAR is a legal mechanism whereby Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer [*Copthorne*].

I understand that some might argue that the decisions of the Supreme Court should not be parsed in the same rigorous way that tax legislation is construed. But in my view a close reading of the Supreme Court’s decisions is inevitable, and I

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38 *OSFC Holdings*, supra note 9, at paragraph 2.
39 *Copthorne*, supra note 27, at paragraph 32.
40 *OSFC Holdings*, supra note 9, at paragraph 69.
41 *Copthorne*, supra note 27, at paragraph 66. See also Rothstein J’s comments cited in note 18, supra.
would be very much surprised if the Supreme Court did not understand this and expect it. As a result, I think it is fair to assume that the Supreme Court chooses its words carefully.

Both OSFC Holdings and Copthorne make it clear that subsection 245(4) is an interpretive provision, not a substantive rule. In OSFC Holdings Rothstein J wrote:

Ascertaining the relevant policy is a question of interpretation. As such, it is ultimately the duty of the Court to make this determination. 42

And in Copthorne he wrote:

The object, spirit or purpose can be identified by applying the same interpretive approach employed by this Court in all questions of statutory interpretation—a “unified textual, contextual and purposive approach.” 43

Thus, GAAR applies to transactions that abuse, frustrate, or defeat the object, spirit, purpose, policy, or underlying rationale of the relevant provisions. The determination of the purpose of the provisions is an interpretive exercise based on a textual, contextual, and purposive analysis of the provisions.

According to the Supreme Court, the provisions of all statutes, including taxing statutes and in particular subsection 245(4), must be interpreted in accordance with the modern rule, which, since Canada Trustco, has also been described by the Supreme Court as the textual, contextual, and purposive approach. The modern approach was adopted by the Supreme Court in its 1984 decision in Stubart Investments, where the court endorsed the following description from Driedger’s Construction of Statutes:

Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament. 44

The modern rule has been reaffirmed by the Supreme Court many times. 45 Although the court has never said so explicitly, lower courts and commentators have universally assumed that the modern rule and the textual, contextual, and purposive approach are identical. This conclusion seems justified because the references in the modern rule to the “grammatical and ordinary sense” of the words, the “entire context,” and

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42 OSFC Holdings, supra note 9, at paragraph 68.
43 Copthorne, supra note 27, at paragraph 70.
45 See, for example, Placer Dome Canada v. Ontario (Minister of Finance), 2006 SCC 20, and Imperial Oil Ltd. v. Canada, 2006 SCC 46. For some reason, however, the Supreme Court has not discussed the approach to statutory interpretation in any of its tax decisions since 2006.
“the object of the Act, and the intention of Parliament” equate to the “textual,” “contextual,” and “purposive” elements of the Supreme Court’s approach.

The question is: What does the interpretive analysis required under subsection 245(4) add to the basic interpretive approach that must first be applied to the relevant provisions of the Act? As noted in the explanatory notes and confirmed by the Supreme Court in *Canada Trustco* and *Copthorne*, GAAR is intended to be a provision of last resort. Rothstein J dealt briefly with this issue in *OSFC Holdings*. In effect, the analysis under subsection 245(4) is the invoking of the policy or purpose to override the words of the Act with respect to transactions that otherwise comply with the letter of the relevant provisions. Rothstein J apparently assumed that provisions of the Act are to be interpreted literally—or, perhaps more accurately, that in applying the modern approach, the literal meaning of the words plays a dominant role in the interpretive process.

In *Copthorne*, Rothstein J explained the relationship between the textual, contextual, and purposive approach that is ordinarily applied to the interpretation of statutes and the textual, contextual, and purposive approach that must be applied under subsection 245(4):

> While the approach is the same as in all statutory interpretation, the analysis [under subsection 245(4)] seeks to determine a different aspect of the statute than in other cases. In a traditional statutory interpretation approach the court applies the textual, contextual and purposive analysis to determine what the words of the statute mean. In a GAAR analysis the textual, contextual and purposive analysis is employed to determine the object, spirit or purpose of a provision. Here the meaning of the words of the statute may be clear enough. The search is for the rationale that underlies the words that may not be captured by the bare meaning of the words themselves.

This is a brave attempt to resolve the uneasy relationship between the ordinary approach to statutory interpretation and the interpretive approach to the determination of abuse under GAAR, but in my opinion, it is unsuccessful. In the first place,
it relies on the assumption that there is a meaningful difference when the same thing is done for different purposes: that is, applying a textual, contextual, and purposive approach to determine the meaning of a provision is somehow different from applying a textual, contextual, and purposive approach to determine the object, spirit, or purpose of that provision. However, the object, spirit, or purpose of the provision, the determination of which is the goal of the subsection 245(4) analysis, is part of the textual, contextual, and purposive analysis that is supposed to be applied in every exercise of statutory interpretation. Therefore, in every case of statutory interpretation, a court should consider the words of the statute and any relevant extrinsic aids to determine the purpose of the provision. That task should have been completed by the time the court arrives at the first stage of the determination of abuse under subsection 245(4) (determination of the object, spirit, or purpose of the relevant provisions).

In my view, there is no other reasonable basis for the distinction that Rothstein J attempts to draw between the ordinary textual, contextual, and purposive approach and the textual, contextual, and purposive approach applied to subsection 245(4). For example, it cannot reasonably be argued that the relevant provisions for the abuse analysis under subsection 245(4) are different from the provisions that are subject to the ordinary textual, contextual, and purposive approach to interpretation. Nor can it reasonably be argued that the purpose of the relevant provisions can be different for the purpose of the ordinary interpretive exercise and for the purpose of the abuse analysis under subsection 245(4).

One possible way to make sense out of the distinction between the two interpretive exercises is that the purpose of the relevant provisions gets more weight in the abuse analysis than in the ordinary interpretive exercise. This is a plausible explanation because the Supreme Court has said many times that since tax provisions are detailed and particular, the text (the literal meaning of the words) must play a dominant role in establishing the meaning of the provisions. Indeed, in the preceding excerpt from _Copthorne_, Rothstein J suggests that this is the case when he refers to “the rationale that underlies the words that may not be captured by the bare meaning of the words themselves.” However, in _Canada Trustco_, the Supreme Court also went on to say that it is invariably necessary to consider the context and purpose of apparently clear words because such contextual and purposive analysis may reveal latent ambiguities.\(^50\) Such ambiguities are then resolved by reference to all of the relevant factors: text, context, purpose, consequences of alternative interpretations, presumptions, etc.\(^51\)

Therefore, this explanation is not internally consistent if it is based on an assumption that the words of the Act are to be interpreted in accordance with their literal meaning. The modern rule is clear that the interpretation of all statutory

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50 _Canada Trustco_, supra note 6, at paragraph 47.

provisions must consider the context and purpose of the legislation as well as the ordinary meaning of the words. Moreover, the practice of the courts accords with the modern rule in this regard. Courts habitually consider all three factors, although in many cases the literal meaning of the words may be accorded more weight. Consequently, the only basis on which this explanation is plausible is if the weight to be attributed to the purpose of the relevant provisions differs in the two interpretive exercises. This rationale, however, does not withstand scrutiny. Such an approach does not and cannot tell a court how much weight to attribute to the purpose; it can only indicate that more weight should be given to purpose under subsection 245(4) than under other provisions. However, even in ordinary cases of statutory interpretation, where the literal meaning of a provision is ambiguous and the context is not helpful in unlocking the meaning, the purpose of the provision—assuming that it can be established with clarity—may be given substantial weight in applying the modern rule. It is inconceivable to me how in such circumstances a court would give more weight to the purpose of the provisions in determining whether there has been abuse under subsection 245(4).

The problem is that, in every interpretive exercise, the interpreter must balance all of the relevant information and assign weight to each factor. It is not as simple as interpreting provisions without giving any or much weight to purpose and a lot of weight or exclusive weight to the text, and then reversing the weighting under subsection 245(4). This is not how we (including judges) interpret words, although it may be how we (including judges) rationalize or justify our conclusions after the fact.

In Canada Trustco and Mathew, the Supreme Court enunciated the following test for abuse under subsection 245(4):

\[\text{Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.}\]

This test is tautological: a transaction will be abusive when it lacks a proper basis relevant to the policy of the provisions of the Act; and, of course, it will lack a proper basis when it is abusive. Further, the “wholly dissimilar” standard seems to have been invented by the court without any basis in the words of GAAR or the explanatory notes; and the court provides no guidance for determining when transactions or relationships are wholly dissimilar to those contemplated by the provisions relied on for the tax benefit. In particular, the reference to relationships is unjustified by anything in the wording of subsection 245(4).

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52 Canada Trustco, supra note 6, at paragraphs 60 and 66; and Mathew, supra note 21, at paragraph 31. For a more detailed criticism of this test, see Brian J. Arnold, “Policy Forum: Confusion Worse Confounded—The Supreme Court’s GAAR Decisions” (2006) 54:1 Canadian Tax Journal 167-209, at 193-94.
Subsequent Supreme Court cases have wisely ignored the formulation of the test for abuse in *Canada Trustco*. (Not surprisingly, in those cases, the court did not explicitly reject that test.) Instead, subsequent cases have focused on what the Supreme Court in *Canada Trustco* identified as three types of abuse and, with a little reverse engineering, have effectively turned this typology into the test of abuse.53 Thus, abuse will be found where

1. the outcome is one that the relevant provisions seek to prevent,
2. the underlying rationale of the relevant provisions is defeated, and
3. the relevant provisions are circumvented in a manner that defeats their object and purpose.

The difficulty with this reformulation of the test is that it does not provide any more meaningful guidance as to when a transaction will be considered to be abusive than the former test did; it merely restates the test in three ways that overlap extensively. When is the outcome of a transaction one that the provisions seek to prevent? When does a transaction defeat the underlying rationale of the provisions or circumvent the provisions in a manner that defeats their object and purpose? The answer is, “When the transaction is abusive”—and we are back to where we started.

What we need is for the Supreme Court to articulate an objective test or tests for the determination of abuse that can be applied by taxpayers, tax officials, and the courts with some degree of certainty.54

**CONCLUSION**

This article argues that the Supreme Court’s approach to the determination of abuse under subsection 245(4) is shifting under the influence of Rothstein J. The determination of the policy or purpose of the provisions of the Act that have been abused will not be restricted to the provisions that the taxpayer relied on for the tax benefit, as suggested by the Supreme Court in *Canada Trustco*, but will include the provisions of the Act read as a whole. Although the relationship between the ordinary approach to the interpretation of the provisions of the Act and the interpretive exercise under subsection 245(4) is still unclear, the court recognizes that it is necessary for the abuse analysis to go beyond the words of the Act in order for GAAR to have meaning. These are important developments; however, there are several other issues involving the determination of abuse that remain to be resolved. The most important issue, in my view, is the need for the Supreme Court to develop objective tests for abuse that can be applied by the courts so that the concept of abuse does not degenerate into a smell test.

53 See *Canada Trustco*, supra note 6, at paragraph 45; *Lipson*, supra note 26, at paragraph 40; and *Copthorne*, supra note 27, at paragraph 72.

54 For example, one possibility might be a comparison of the quantum of the tax benefits and the commercial benefits of the transaction.
Policy Forum: Defending Against a GAAR Reassessment

Alan M. Schwartz and Kevin H. Yip*

KEYWORDS: GAAR ■ REASSESSMENTS ■ DEFENCE ■ SURPLUS ■ INCOME SPLITTING ■ LOSSES

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INTRODUCTION

This article discusses strategic considerations in defending against an assessment or reassessment where the general anti-avoidance rule (GAAR) is raised as an issue. We emphasize the importance of knowing (either by notice or by inference) the factual transactions and the specific provisions of the Income Tax Act (Canada)\(^1\) on which the minister intends to base the GAAR reassessment.\(^2\) Once these are disclosed, the

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1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

2 The references to GAAR in this article are to section 245 of the Act. The provincial income tax statutes also have general anti-avoidance rules. Given the similarity of the federal and provincial rules, the issues discussed in this article should also apply to provincial GAAR reassessments. See, for example, Husky Energy Inc. v. Alberta, 2012 ABCA 231; Canada Safeway Limited v. Alberta, 2012 ABCA 232; and Inter-Leasing, Inc. v. Ontario (Revenue), 2013 ONSC 2927.
taxpayer should proactively rebut the minister’s attempt to prove the misuse or abuse of specific provisions and ensure that a unified textual, contextual, and purposive interpretation of the provision is made.

Four related topics will be covered in this article:

1. emphasizing that GAAR is a legal test and not a smell test;
2. effectively framing the series of transactions;
3. proactively rebutting the minister’s attempt to prove the clear policy of the specific provisions at issue; and
4. mounting a defence to the minister’s attempt to prove misuse or abuse of the Act.

The well-known test for the application of GAAR was established by the Supreme Court of Canada in the Canada Trustco case. The test has three parts. First, there must be a tax benefit arising from a transaction or from a series of transactions that includes that transaction. Second, there must be an avoidance transaction, in that the transaction or series of transactions at issue cannot reasonably be considered to have been undertaken or arranged primarily for a bona fide purpose other than to obtain the tax benefit. Third, there must be abusive tax avoidance, in that the transaction is not consistent with the object, spirit, and purpose of the provisions relied on by the taxpayer in obtaining the tax benefit.

Fundamental to defending against a GAAR reassessment is understanding and dealing with the allocation of the burden of proof in respect of the three-part test. The taxpayer has the burden to refute the existence of a tax benefit and an avoidance transaction. The minister, on the other hand, must establish that the abusive nature of the transaction is clear. If the existence of abusive tax avoidance is unclear, in that the minister cannot provide clear evidence, the benefit of the doubt goes to the taxpayer.

GAAR—A LEGAL TEST, NOT A SMELL TEST

Even for many tax practitioners, it is tempting to reduce GAAR to a smell test. The courts have repeatedly reminded us to adhere to the legal application of the GAAR test and not to be distracted by any moral or normative considerations divorced from a rigorous interpretation of the transactions and provisions at issue.

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3 Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54, at paragraph 66.
4 Subsection 245(1), the definition of “tax benefit,” and subsection 245(2).
5 Subsections 245(2) and (3).
6 Subsection 245(4).
7 Canada Trustco, supra note 3, at paragraph 63.
8 Ibid., at paragraph 65.
9 Ibid., at paragraphs 62 and 66.
In *Jabs Construction*, a pre-*Canada Trustco* case, Bowman J commented that GAAR is an extreme sanction that “should not be used routinely every time the Minister gets upset just because a taxpayer structures a transaction in a tax effective way, or does not structure it in a manner that maximizes the tax.”\(^{10}\) Years later in *XCO Investments*, Bowman J reiterated that anti-avoidance provisions are

not intended as a means of punishment for offending the Minister’s olfactory sense. They do not give the Minister carte blanche to impose sanctions for transcending his notion of fiscal rectitude.\(^{11}\)

In *Copthorne*,\(^ {12}\) the Supreme Court emphasized the importance of applying GAAR as a legal test and reiterated the taxpayer’s right to non-abusive tax planning. The Supreme Court said:

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*).\(^ {13}\)

The Supreme Court in *Copthorne* reminded the lower courts—and the Canada Revenue Agency (CRA)—why a rigorous application of GAAR is important:

A court must be mindful that a decision supporting a GAAR assessment in a particular case may have implications for innumerable “everyday” transactions of taxpayers. . . . [b]ecause of the potential to affect so many transactions, the court must approach a GAAR decision cautiously. . . .

For this reason, “the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear” (*Trustco*, at para. 50). The court’s role must therefore be to conduct an objective, thorough and step-by-step analysis and explain the reasons for its conclusion.\(^ {14}\)

Tax practitioners have an important role to play in ensuring that a thorough and objective standard is consistently applied in the handling of GAAR cases, starting with the audit or proposal letter. Nonetheless, it must be recognized that transactions or plans that are “smelly” do inherently raise the litigation risk and reputational risk for taxpayers. Accordingly, when considering a proposed transaction, tax practitioners

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\(^{10}\) *Jabs Construction Ltd. v. R*, 99 DTC 729, at paragraph 48.

\(^{11}\) *XCO Investments Ltd. v. The Queen*, 2005 TCC 655, at paragraph 40; aff’d. 2007 FCA 53. Bowman J was referring to “anti-avoidance sections such as 103 and 245.” He also noted that where a specific anti-avoidance provision covers a transaction but does not provide an adequate remedy, GAAR is not there to allow the minister to top up the remedy that the minister believes inadequate.

\(^{12}\) *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63.

\(^{13}\) Ibid., at paragraph 65.

\(^{14}\) Ibid., at paragraphs 67-68.
should take into account the potential risk of a future GAAR reassessment and tax litigation arising from the transaction. Often, this means that the GAAR analysis should be done in the early planning phases.

**Framing the Series of Transactions: Tax Benefit and Avoidance Transaction**

Although practice and the jurisprudence since *Canada Trustco* have shown that the case for applying GAAR will often ultimately be determined at the misuse or abuse stage of the GAAR analysis, it is important not to concede too quickly the existence of a tax benefit and an avoidance transaction, and to ensure that the first two parts of the GAAR analysis are thoroughly considered.

Where there is a series of transactions, all three parts of the GAAR analysis are implicated, in that for GAAR to apply, the series of transactions must result in a tax benefit,\(^{15}\) and there must be at least one transaction in the series that can reasonably be considered to be an abusive avoidance transaction.\(^{16}\) Accordingly, tax practitioners should not ignore the framing of the series of transactions, nor should they necessarily accept the minister’s proposals (at the audit and objection stages) or the factual assumptions (at the court stage) relating to the series of transactions.

The Supreme Court in *Copthorne* gave a broad meaning to “series of transactions,” noting that the statutory definition in subsection 248(1) expands the common-law meaning. The court explained that, whereas the common-law definition of a series requires that “each transaction in the series [is] pre-ordained to produce a final result,” subsection 248(10) goes further by deeming “any related transactions or events completed in contemplation of” a series to be part of that series.\(^{17}\)

Under the expanded meaning, for a transaction to be part of a series, the series must have been taken into account when the decision was made to undertake the related transaction, in the sense that that transaction was undertaken “in relation to” or “because of” the series.\(^{18}\) On the basis of *Copthorne*, it is clear that the statutory series allows either a prospective or a retrospective connection of a transaction related to a common-law series.\(^{19}\)

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15 As defined in subsection 245(1).
16 Reading subsections 245(3) and (4) conjunctively.
17 *Copthorne*, supra note 12, at paragraph 43 (citing the common-law definition of “series” in *OSFC Holdings Ltd. v. Canada*, 2001 FCA 260, at paragraph 24).
18 *Copthorne*, supra note 12, at paragraph 47: “Although the ‘because of’ or ‘in relation to’ test does not require a ‘strong nexus,’ it does require more than a ‘mere possibility’ or a connection with ‘an extreme degree of remoteness.’” The length of time, and any intervening events between the series and the related transaction, are also relevant to the analysis.
19 Ibid., at paragraph 56. This interpretation of subsection 248(10) appears to be inconsistent with the French version of subsection 248(10), which contemplates that the transaction to be added to the common-law series must be subsequent to the transaction to be added under subsection 248(10). See Alan M. Schwartz, *GAAR Interpreted: The General Anti-Avoidance Rule* (Toronto: Carswell) (looseleaf), 5-434.2.
The key to establishing the series of transactions is the availability of evidence showing the motivations behind the transactions, since it is the taxpayer’s onus to rebut any assumptions made by the minister. Contemporaneous documentation of a non-tax rationale, if any, should be retained at the planning stages in order to assist in the future defence against a GAAR reassessment. However, taxpayers should be careful not to provide a road map or to waive privilege, if applicable, in providing such documents.

Taxpayers have generally been unsuccessful in rebutting the existence of a tax benefit, and slightly more successful in rebutting the existence of an avoidance transaction. Univar is the lone case in which the Tax Court found no tax benefit. As the Supreme Court noted in Canada Trustco, the existence of a tax benefit is clear where a deduction is claimed. In situations where no deduction is claimed or where it is otherwise not clear that there is a tax benefit, the tax benefit can only be established by comparison with an alternative arrangement. Under the comparative approach, the alternative arrangement must be one that “might reasonably have been carried out but for the existence of a tax benefit.”

In light of the Supreme Court’s statement regarding the existence of a tax benefit, a tax deduction appears to be a tax benefit even where the deduction offsets an income inclusion. For example, a subsection 112(1) deduction that offsets an income inclusion under subparagraph 82(1)(a)(i) or (a.1)(i) in respect of a dividend receipt appears to be considered a tax benefit under the Supreme Court’s guidance. However, we suggest that this is one example of a situation where the comparative approach should be applied. We suspect that this will be an area of dispute in the future.

There are at least three recent cases in which the court found no avoidance transaction: Spruce Credit Union, McClarty, and Swirsky.

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21 Ibid., at 350-51.
22 Univar Canada Ltd. v. The Queen, 2005 TCC 723.
23 Canada Trustco, supra note 3, at paragraph 20.
24 In Univar, supra note 22, at paragraphs 42-44, Bell J compared the subject transaction with an alternative arrangement and concluded (ibid., at paragraph 42) that, on the basis of the evidence, it was clear that the taxpayer never would have entered into an alternative transaction.
26 In Spruce Credit Union v. The Queen, 2012 TCC 357, at issue was a section 112 dividend deduction, and the tax benefit issue was conceded.
27 Ibid.
28 McClarty Family Trust v. The Queen, 2012 TCC 80.
29 Swirsky v. The Queen, 2013 TCC 73.
In *Spruce Credit Union*, the Tax Court affirmed that a transaction, or a step in a series of transactions, will be an avoidance transaction if it is undertaken or inserted primarily for tax purposes. According to the court, in *Spruce Credit Union* the overall transactions had a non-tax purpose, and, in contrast to the facts in *Copthorne*, no step was inserted or undertaken primarily for tax purposes.\(^{30}\) The court noted:

> The act of choosing or deciding between or among alternative available transactions or structures to accomplish a non-tax purpose, based in whole or in part upon the differing tax results of each, is not a transaction. Making a decision cannot be an avoidance transaction.\(^{31}\)

This case reinforces the concept that a transaction in a series of transactions that reduces tax is not necessarily an avoidance transaction. For example, the insertion of a section 85 election step would not necessarily be an avoidance transaction even though the purpose of a section 85 rollover is clearly to defer tax. If the taxpayer has a non-tax reason to contribute assets to a corporation, the taxpayer is entitled to choose to do so in a way that minimizes tax.

In *McClarty*, the Tax Court found that there was no avoidance transaction, noting that every single transaction in the series had a bona fide purpose. The primary motivating element of the transactions at issue was the intention to protect assets.\(^{32}\)

Similarly, in *Swirsky*, the Tax Court found that there was no avoidance transaction.\(^ {33}\) In that case, there was evidence that the taxpayer was concerned about liability owing to the real estate downturn and followed a creditor-proofing plan provided by his adviser. The case was also unusual in that the minister had the burden of proving the existence of an avoidance transaction because the issue was raised in reply.

Another interesting aspect of *Swirsky* is that the minister argued that the transactions could not have creditor-proofing as a non-tax purpose because the transactions were not effective in providing creditor-proofing. Although the Tax Court ultimately found that the minister was unable to prove that the transactions did not achieve the creditor-proofing purpose, it should not have been necessary for the non-tax purpose to have been effective. There must be intention, and the transactions, of course, cannot be a sham, but the non-tax purpose should not necessarily have to have been successful, since it is the taxpayer’s intention that should matter.

The above cases indicate that an argument can be made that no avoidance transaction exists where a transaction, or a series of transactions, is initiated in response to an external change in the commercial or regulatory environment of the business.\(^ {34}\)

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30 *Spruce Credit Union*, supra note 26, at paragraph 92.
31 Ibid., at paragraph 93.
32 *McClarty*, supra note 28, at paragraph 53.
33 *Swirsky*, supra note 29.
34 That is, a non-tax-related external change. In *Copthorne*, supra note 12, at paragraph 48, the Tax Court judge was aware of the intervening introduction of a change in the foreign accrual
Contemporaneous documentation that can provide evidence of this external purpose will be helpful in rebutting the existence of an avoidance transaction.

Times of financial stress, compliance with directives from regulators, and arm’s-length acquisitions all provide opportunities for tax planning, since taxpayers are entitled to minimize the taxes arising from the execution of these transactions. This is a fundamental principle established in the Duke of Westminster case.

**PROACTIVELY REBUTTING THE MINISTER’S ATTEMPTS TO PROVE A CLEAR POLICY**

The minister has the burden to prove abusive tax avoidance because the minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions relevant to the transactions at issue. The minister is required to identify the object, spirit, or purpose of the provisions that are alleged to have been abused; to set out the policy with reference to those provisions; and to identify the extrinsic aids relied upon. For this reason, in defending against a GAAR reassessment, the taxpayer should try to obtain the minister’s audit or reassessment position with respect to the misuse or abuse analysis as early as possible, including the specific provisions relied on or that will be relied on by the minister.

In Birchcliff, the Tax Court granted a motion by the taxpayer demanding that the minister disclose the tax policy that the CRA relied on in reassessing the taxpayer under GAAR. This decision supports the principle that a taxpayer is entitled to early disclosure of tax policy so that the taxpayer may properly respond to the allegations of the minister, especially in a GAAR reassessment. We submit that this principle should be extended to the proposal letter stage, so that taxpayers have an early chance to respond to the minister’s concerns after an audit.

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35 Rothstein J noted in Copthorne, supra note 12, at paragraph 120, that whether transactions are between parties dealing at arm’s length or not at arm’s length should be immaterial in determining whether there is an avoidance transaction.


37 Canada Trustco, supra note 3, at paragraph 65.

38 Ibid., at paragraph 64.


40 Access to tax policy information earlier in the tax dispute resolution process would also promote settlement and the narrowing of issues. At the administrative stage of the dispute resolution process (that is, at audit or on the filing of a notice of objection), a taxpayer has a limited ability to require that the minister show his or her case. There are no pleadings and no discovery process at this stage. Although the taxpayer may receive an audit proposal letter, there is no requirement for the CRA to provide it. Earlier access to tax policy information allows the parties to reasonably and fairly address issues on the basis of complete information.
There is also a broader principle supporting the taxpayer’s entitlement to know the minister’s view as to the policy of the various provisions in the Act. Because the Canadian tax system is a self-assessment system, it is important that taxpayers be able to determine the tax consequences of proposed transactions before they are implemented, including whether GAAR might apply.41

Evidence of Clear Policy

In Canada Trustco, the Supreme Court stated that in determining the object, spirit, or purpose of a provision, one can refer to “permissible extrinsic aids.”42 The Supreme Court did not articulate what were permissible extrinsic aids, although it did refer extensively to the Department of Finance explanatory notes. Presumably, Hansard, budget papers, and statements of the minister of finance would be permissible.

We propose that permissible extrinsic aids be given a broad meaning. As Rothstein J noted in Copthorne,

> The GAAR is a legal mechanism whereby Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer.43

Rothstein J further noted that while the textual, contextual, and purposive approach is the same as in other non-GAAR cases, the analysis seeks to determine a different aspect of the statute. Rather than determining the meaning of the statute, the GAAR analysis requires a search for “the rationale that underlies the words that may not be captured by the bare meaning of the words themselves.”44

This suggests to us that the extrinsic evidence supporting the GAAR analysis should be broader than that normally used to interpret or discern the meaning of statutes or other provisions of the Act. Such evidence includes contemporaneous documents indicating what the government policy makers and legislative drafters were considering at the time the provisions were drafted and introduced. We also

41 However, in STB Holdings Ltd. v. The Queen, 2002 FCA 386, the Federal Court of Appeal noted that a taxpayer cannot self-assess under GAAR in filing its tax return. The Court of Appeal agreed with Miller J of the Tax Court of Canada when he said that GAAR is not a planning tool for the taxpayer, and the taxpayer cannot apply GAAR to itself in filing its return (ibid., at paragraphs 11-13). In Copthorne Holdings Ltd. v. The Queen, 2007 TCC 481, at paragraphs 77-78, Campbell J confirmed that even if GAAR is applicable to a transaction or a series of transactions, there was no basis or ground for the imposition by the minister of penalties, let alone gross negligence penalties, given that (1) the taxpayer had no ability in filing its tax return to self-assess or apply GAAR, and (2) the fact that the minister needed to resort to the application of GAAR was evidence that the taxpayer had, in filing its return, strictly complied with the letter of the law.

42 Canada Trustco, supra note 3, at paragraph 55.

43 Copthorne, supra note 12, at paragraph 66.

44 Ibid., at paragraph 70.
suggest that extrinsic evidence should be broader than the “official policy” set out in the technical notes and could, for example, include the policy choices not to do certain things. Given the “unusual duty” that the GAAR analysis places on the courts (and therefore on taxpayers considering proposed transactions), and given the complex policy arguments that must inform the misuse and abuse stage of that analysis, this broad view of the permissible extrinsic aids is in our view necessary. We expect that this too will be an area of dispute in the future.

The Meaning of “Clear”

As noted earlier, in Canada Trustco the Supreme Court said that if the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.45 In Lipson, LeBel J stated that the minister continues to bear the burden of proving on a balance of probabilities that the avoidance transaction results in a misuse or abuse within the meaning of subsection 245(4).46 In Copthorne, Rothstein J repeated that “the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear.”47

Taking these statements together, the Supreme Court is confirming that the legal burden of proof as regards abuse and misuse is on the minister, and the civil standard of balance of probabilities applies. However, the civil standard can require greater clearness of proof. In such cases, the trier of fact should carefully scrutinize the evidence.48

Even though the onus is on the minister to prove a clear policy, taxpayers should proactively rebut the minister’s evidence regarding the policy of the provisions at issue. One way to do so is by providing evidence of an alternate policy, or evidence that there was no policy, as opposed to that alleged by the minister.

As noted above, the limits of what constitutes “permissible extrinsic aids” have yet to be settled. Nonetheless, as we have argued, a broad range of materials should inform the debate. These would include, in addition to policy papers and technical notes, other publicly available documents such as government commission reports, textbooks, and academic papers.

Access-to-Information or Freedom-of-Information Requests

We have stated above that it is important to obtain at an early stage the minister’s view of the transaction or series of transactions at issue, the specific provisions of the Act allegedly abused, and the policy underlying those provisions.

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45 Canada Trustco, supra note 3, at paragraph 66.
46 Lipson v. Canada, 2009 SCC 1, at paragraph 21.
47 Copthorne, supra note 12, at paragraph 68 (quoting Canada Trustco, supra note 3, at paragraph 50).
One strategy that taxpayers may find useful is making a request for information from the CRA or the Department of Finance. A request can be made for the taxpayer’s own information either informally or pursuant to the Privacy Act 49 (for individuals) or the Access to Information Act 50 (for corporations). 51 An access-to-information request can also be made for government manuals. 52

Taxpayers can also try to ask for records related to the policy of specific provisions of the Act and with respect to certain types of transactions. A request can be made for the records related to the taxpayer’s file or the general policy with respect to specific provisions. There are exemptions and exclusions from disclosure such as solicitor-client privilege, “advice or recommendations,” and third-party information. However, these exceptions and exclusions should be interpreted in a limited and specific way. 53

The identity of the requester and the reasons for the request are generally irrelevant in access-to-information and freedom-of-information legislation in Canada. In particular, where the taxpayer is considering entering into a transaction where there may be a risk of a GAAR reassessment, the taxpayer should be entitled to access information about the tax policy of the specific provisions at issue. Such information is necessary for taxpayers to properly determine the tax consequences of transactions and is consonant with tax certainty, predictability, and fairness.

The scope of the policy information available to taxpayers and other Canadians is an evolving area of law. Early access to policy information is consistent with the scheme of the Act, GAAR, and the self-assessment tax system in Canada.

**Mounting a Defence to the Minister’s Attempt to Prove Misuse or Abuse**

The misuse or abuse stage of the GAAR analysis has two parts. First, the object, spirit, and purpose of the specific provisions allegedly abused must be determined. Second, the transactions must be shown to frustrate the identified purpose. 54 The minister must clearly demonstrate that the transaction is an abuse of the Act. The GAAR jurisprudence indicates limits to how the minister can prove misuse or abuse.

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49 RSC 1985, c. P-21, as amended.
50 RSC 1985, c. A-1, as amended.
51 See paragraph 241(5)(a) of the Act. Taxpayers should consider requesting the CRA Audit Report (T20) and the CRA Appeals Report (T401).
52 Canada Revenue Agency, “The CRA’s Information Holdings,” CRA website, June 27, 2013 (www.cra-arc.gc.ca/gncy/tp/nfsrc-eng.html). Readers may also want to check their local CRA reading room.
53 Canadian Council of Christian Charities v. Canada (Minister of Finance), [1999] 3 CTC 123, at paragraph 15 (FCTD). See also Ontario (Finance) v. Ontario (Information and Privacy Commissioner), 2012 ONCA 125.
54 Copthorne, supra note 12, at paragraphs 69-71.
In *Hill*, a pre-Canada Trustco case, the Tax Court held that the minister had failed to identify a policy, stating that the minister must do more than recite the words of the Act.\(^\text{55}\) In proving a clear policy, the minister cannot search for an overriding policy that is not based on a unified textual, contextual, and purposive interpretation of the specific provisions at issue. Furthermore, the series of transactions cannot be recharacterized to fit a policy, nor can the minister rely on the policy of unrelated provisions or transactions.\(^\text{56}\) The recharacterization may come afterward as a remedy, but only after the misuse or abuse is proven (that is, after it has been determined that GAAR applies).\(^\text{57}\)

In *Howe*, the Tax Court rejected the GAAR reassessment, stating that the transactions could not be collapsed into a share purchase either on the basis of an economic substance analysis or on the basis of GAAR.\(^\text{58}\) Citing an earlier decision by the Federal Court of Appeal in another case involving the recharacterization of transactions, the Tax Court agreed that “a transaction cannot be portrayed as something which it is not.”\(^\text{59}\)

In *Imperial Oil*,\(^\text{60}\) the Federal Court of Appeal indicated that when undertaking the misuse or abuse analysis, a court should also consider provisions related to the one on which the taxpayer specifically relies. The court noted that for GAAR to apply in that case, the minister must show that the provisions relating to the investment allowance had been misused, by demonstrating that the loan at issue was structured so as to defeat a clear and unambiguous policy underlying subsection 181.2(4).\(^\text{61}\)

Although, in *Imperial Oil*, the Court of Appeal discussed at length the general policy in respect of the part I.3 tax on large corporations, the court noted that the general statutory objectives were only of peripheral relevance and provided only the broader context for determining whether the loan at issue constituted a misuse for the purposes of the GAAR analysis. The court also noted that the CRA had not identified any clear legislative policy underlying the investment allowance provisions. As to the CRA’s views regarding the application of GAAR, as set out in administrative publications and at tax conferences, the court observed that they were only views, and did not carry any special weight with respect to the interpretation or application of the Act.\(^\text{62}\)

\(^{55}\) *Hill v. The Queen*, 2002 DTC 1749, at paragraph 60.

\(^{56}\) *Canada Trustco*, supra note 3, at paragraph 59.

\(^{57}\) Subsection 245(5).

\(^{58}\) *Howe v. The Queen*, 2004 TCC 719, at paragraph 29. See also *McMullen v. The Queen*, 2007 TCC 16, at paragraph 47 (discussed in the text below at note 89 and following).

\(^{59}\) Ibid. (quoting from comments by the Federal Court of Appeal in *The Queen v. Canadian Pacific Limited*, 2002 DTC 6742).

\(^{60}\) *Canada v. Imperial Oil Ltd.*, 2004 FCA 36.

\(^{61}\) Ibid., at paragraph 60.

\(^{62}\) Ibid., at paragraph 64.
In practice, this means that the minister’s asserted relevant policy must actually have application to the transaction or series of transactions at issue. We discuss below specific cases that illustrate the challenge of identifying an overarching policy.

**Stop-Loss Provisions**

The courts have found that there is no general unexpressed policy regarding the stop-loss provisions, but appear to have expressed a general policy regarding business losses.

At issue in *Landrus*63 were the terminal loss provisions in subsection 20(16) and various stop-loss rules. The minister conceded that there is no express restriction in subsection 20(16) on claiming a terminal loss where both the transferor and the transferee of the depreciable property are partnerships and all the members of the transferor partnership are members of the transferee partnership.

In the GAAR reassessment, the minister submitted that the stop-loss provisions in subparagraph 40(2)(g)(i), subsection 85(4), paragraph 40(2)(e), and subsection 85(5.1) are part of the legislative context of subsection 20(16) and are relevant to the misuse and abuse analysis. However, the Court of Appeal found that the minister had overstated the extent and the comprehensiveness of the policy underlying these stop-loss provisions. The court found that the precisely drafted rules set out detailed conditions for the denial of a loss that would otherwise arise on the disposition of a particular type of property.

It was important that one variation among the various stop-loss rules was the degree of connection or relationship required, since certain stop-loss rules were driven by the relationship between the parties to the transactions and others were not. The Court of Appeal noted that the specific relationships indicate that the rules are exceptions to a general policy of allowing losses in respect of dispositions. The court concluded that the minister had not shown that there is a general or overall policy in the Act prohibiting losses on any transfer between related parties or parties described as forming an economic unit.

*1207192 Ontario*,64 *Triad Gestco*,65 and *Global Equity*66 are a trilogy of cases involving stock dividends that shifted value from common shares to preferred shares and thereby gave rise to a loss on the common shares.

In the first two cases, the minister relied on the specific capital loss rule in subparagraph 40(2)(g)(i) and the superficial loss rule in section 54. *Landrus* was distinguished on the basis that there was real economic loss in that case. The Tax Court in *Triad Gestco* went on to say that a contextual and purposive interpretation discloses that

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64 1207192 *Ontario Limited v. The Queen*, 2011 TCC 383.
65 *Triad Gestco Ltd. v. The Queen*, 2011 TCC 259.
the object, spirit, and purpose of the relevant provisions were to allow only the recognition of “true capital losses incurred outside the same economic unit.”

The *Global Equity* case was different from the other two in the trilogy, in that business losses were at issue. The Federal Court of Appeal did find an overall policy related to business losses. The court held that the minister could not rely on provisions of the Act relating to capital losses in order to ascertain the object, spirit, and purpose of the relevant provisions since the specific provisions at issue concerned the use of business losses, not capital losses. The capital loss provisions are distinct and usually operate independently from one another. The court stated that the minister’s approach “would send this Court on the search for an overreaching policy to override the wording of the provisions of the Act, and it would inappropriately place the formulation of taxation policy in the hands of this Court.”

The court focused on sections 3, 4, 9, and 11, noting that since the key expressions “income,” “profit,” and “loss” used in those sections remain undefined, “GAAR . . . should not be used to impute a special overarching meaning to these expressions.” In the end, the court did find that the fundamental rationale underlying the provisions at issue is that for business losses to be deductible, the losses “must be grounded in some form of economic or business reality.”

One way to reconcile *Landrus* and the trilogy of loss cases is that courts have been reluctant to apply GAAR in cases where there are specific and detailed rules dealing with the transactions in question. On the other hand, the statement by the Court of Appeal in *Global Equity* regarding “economic or business reality” appears to be a departure from the Supreme Court of Canada’s clear guidance against using an economic substance test.

**Income Splitting**

It is less clear whether there is an overarching purpose against income splitting. In *Overs*, the Tax Court concluded, in brief reasons, that the transactions were not abusive tax avoidance. The taxpayer had relied on the attribution rules in subsection 74.1(1) to claim a loss in respect of interest incurred on borrowed money. The minister alleged that there was a misuse of subsection 74.1(1), among other provisions. Subsection 74.1(1) prevents income splitting among family members but is not intended to allow the deduction of interest and other personal expenses. The minister also alleged that the transactions constituted an abuse of the Act as a whole.

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67 *Triad Gestco*, supra note 65, at paragraph 55.
68 *Global Equity*, supra note 66, at paragraph 52.
69 Ibid., at paragraph 59.
70 Ibid., at paragraph 62.
71 *Canada Trustco*, supra note 3, at paragraph 57.
The Tax Court referred to Canada Trustco regarding the minister’s onus to establish that the avoidance transaction frustrates or defeats the purpose for which the tax benefit was intended, and concluded, on the basis of the evidence, that none of the transactions were “abusive tax avoidance” transactions.\footnote{Ibid., at paragraphs 23-24 (citing Canada Trustco, supra note 3, at paragraph 52).} \textit{Overs} is an early GAAR judgment that appears to have been overruled by \textit{Lipson}.

In \textit{Lipson}, at issue were subsection 73(1) and the attribution rules in subsections 74.1(1) and 74.2(1). The Supreme Court was strongly divided, and three separate opinions were issued. LeBel J, writing for the majority, noted that “the effect of s. 73(1) is to facilitate interspousal transfers of property without triggering immediate tax consequences.”\footnote{\textit{Lipson}, supra note 46, at paragraph 31.} However, the attribution rules in sections 74.1 through 74.5 are anti-avoidance provisions, the purpose of which 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 them. LeBel J noted that it was strange that subsection 74.1(1) could result in a reduction of the total amount of tax payable on the income of the transferred property.\footnote{Ibid., at paragraph 42.} He concluded that the taxpayers’ use of the provision in this way qualified as abusive tax avoidance\footnote{Ibid., at paragraph 48.} but provided little analysis of the specific policy behind the provision. The majority appeared not to approve of the fact that a specific anti-avoidance rule was being used to facilitate abusive tax avoidance.

Binnie J (with Deschamps J concurring) thought that the minister had not shown that the abusive nature of the transactions was clear. He appeared to disagree with the minister’s “selective view” that subsection 74.1(1) could attribute net dividend income to increase tax payable by the taxpayer, but that it was abusive for subsection 74.1(1) to be used to attribute losses to the taxpayer, even though subsection 74.1(1) itself draws no distinction between income and losses and even though the income and losses were associated with the same transferred shares.\footnote{Ibid., at paragraph 62.}

Binnie J felt that the minister’s argument “[painted] with too broad a brush” and failed to identify a specific policy shown to be frustrated by the taxpayer.\footnote{Ibid., at paragraph 65.} He reiterated that it was not for the courts to search for an overriding policy and use such a policy to override the wording of the provisions of the Act. This, again, would run counter to the principles of certainty, predictability, and fairness.\footnote{Ibid., at paragraph 67.}

In \textit{Swirsky}, Paris J noted in obiter that he would have great difficulty in distinguishing the case before him from \textit{Lipson}, presumably affirming that the transactions

\begin{footnotes}
\footnote{Ibid., at paragraphs 23-24 (citing Canada Trustco, supra note 3, at paragraph 52).}
\footnote{\textit{Lipson}, supra note 46, at paragraph 31.}
\footnote{Ibid., at paragraph 42.}
\footnote{Ibid., at paragraph 48.}
\footnote{Ibid., at paragraph 62.}
\footnote{Ibid., at paragraph 65.}
\footnote{Ibid., at paragraph 67.}
\end{footnotes}
Dividend Stripping/Surplus Stripping

The practice of dividend stripping or surplus stripping has been a source of dispute between taxpayers and tax authorities for many years. It is therefore not surprising that a large number of GAAR cases are surplus-stripping cases. Despite this activity and the concern of the tax authorities, the courts have found that there is no overarching policy against surplus stripping.

Before the Supreme Court’s decision in Canada Trustco, the Tax Court found an overarching policy against surplus stripping in two cases, McNichol and RMM Canadian Enterprises. However, in Geransky, Bowman J (who had also decided RMM Canadian) noted that jurisprudence under section 245 should develop on a case-by-case basis and found that the transactions did not result in a misuse or abuse of the provisions of the Act. Bowman J stated that where a taxpayer has applied the provisions of the Act and has managed to avoid the pitfalls, the minister cannot say that because the taxpayer avoided the shoals and the traps of the Act, and did not carry out the commercial transaction in a manner that maximized tax, GAAR is to be used to fill in the gaps.

Other cases since Canada Trustco diverge further from the earlier cases. In Evans, Bowman J declined to find a misuse or abuse, stating:

The only basis upon which I could uphold the Minister’s application of section 245 would be to find that there is some overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends, and where they are not the Minister is permitted to ignore half a dozen specific sections of the Act. This is precisely what the Supreme Court of Canada has said we cannot do.

80 Swirsky, supra note 29, at paragraph 75. The Tax Court did not need to consider the misuse or abuse question since the minister failed to show that the transactions at issue were avoidance transactions. Paris J also noted, ibid., that while the facts in Swirsky were similar to those in Overs, the decision in Overs “has been implicitly overruled” by Lipson. In addition, Paris J found that subsection 74.5(11) did not apply, noting that the dissent by Rothstein J in Lipson (supra note 46, at paragraph 102) did not preclude a court from considering GAAR where a specific provision might also apply: Swirsky, supra note 29, at paragraph 65.

81 Gwartz v. The Queen, 2013 TCC 86, at paragraph 53.


83 Paul Hickey, “CRA’s GAAR Update” (2013) 21:1 Canadian Tax Highlights 3-4 (citing GAAR statistics provided by the CRA at the Canadian Tax Foundation’s 2012 annual conference).

84 McNichol v. The Queen, 97 DTC 111 (TCC).

85 RMM Canadian Enterprises v. The Queen, 97 DTC 302 (TCC).

86 Geransky v. The Queen, 2001 DTC 243, at paragraphs 27 and 37-40 (TCC).

87 Ibid., at paragraph 42.

88 Evans v. The Queen, 2005 TCC 684, at paragraph 30.
In *McMullen*, the Tax Court referred to the above paragraph in *Evans* and held that the transactions at issue did not

defeat or frustrate the object, purpose or spirit of any of the provisions of the Act. Those transactions do not lack economic substance. They were real and had legal effect. They were not shams. There was a genuine change in the legal and economic relationships between the two former shareholders.

The Tax Court concluded that the minister had not persuaded the court, or presented any evidence establishing, that there was any abuse of the Act read as a whole, or that the policy of the Act read as a whole is designed so as to necessarily tax corporate distributions as dividends in the hands of shareholders.

Similarly, in *Desmarais*, the Tax Court acknowledged that the specific provisions at issue must 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. The Tax Court also acknowledged the minister’s argument that there was an abuse of the Act read as a whole, “especially of its rules designed to tax in the hands of the company’s shareholders any distribution of its surpluses and its rules designed to prevent a company from having its surplus stripped” (referring, in particular, to sections 84, 84.1, and 212.1 and subsection 85(2.1)). In the end, however, the Tax Court focused on a unified textual, contextual, and purposive analysis of the specific provision in section 84.1.

It is difficult to reconcile the finding in *Desmarais* with that of Bowman J in *Evans*. As noted above, Bowman J found no overarching principle of Canadian tax law that requires that corporate distributions to shareholders be taxed as dividends. It should be noted, though, that the court in *Desmarais* did focus specifically on section 84.1 despite its earlier comments on an abuse of the Act read as a whole.

Nonetheless, as a result of the Supreme Court’s decision in *Copthorne*, it is settled that there is no overarching policy on surplus stripping. As the court stated,

Copthorne submits that such a conclusion [that Parliament intended to limit the aggregation of paid-up capital (PUC) on a vertical amalgamation] could only rest upon a general policy against surplus stripping. It argues that no such general policy exists and therefore the object, spirit and purpose of s. 87(3) cannot be to prevent surplus stripping by the aggregation of PUC. This argument is based upon this Court’s admonition in *Trustco* that “courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions

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89 *McMullen*, supra note 58.
90 Ibid., at paragraph 54.
91 Ibid., at paragraph 56.
92 *Desmarais v. The Queen*, 2006 TCC 44.
93 Ibid., at paragraph 28.
in issue” (para. 41). What is not permissible is basing a finding of abuse on some broad statement of policy, such as anti-surplus stripping, which is not attached to the provisions at issue. However, the tax purpose identified in these reasons is based upon an examination of the PUC sections of the Act, not a broadly stated policy. The approach addresses the rationale of the PUC scheme specifically in relation to amalgamation and redemption and not a general policy unrelated to the scheme under consideration.94

In Copthorne, Rothstein J focused on the purpose of subsection 87(3), noting that while continuity of the PUC of the shares of an amalgamated corporation in a horizontal amalgamation is one of the purposes of subsection 87(3), the parenthetical portion dealing with vertical amalgamations, which functions to cancel the PUC of the shares, reflects an additional purpose. Accordingly, the transactions were found to be abusive on the basis of the rationale of the PUC scheme specifically in relation to amalgamations and redemptions, and not on the basis of an unrelated general scheme.

Rothstein J further confirmed that there is no general policy against corporate reorganizations:

Copthorne also argues that the Act does not contain a policy that parent and subsidiary corporations must always remain as parent and subsidiary. I agree. There is no general principle against corporate reorganization. Where corporate reorganization takes place, the GAAR does not apply unless there is an avoidance transaction that is found to constitute an abuse. Even where corporate reorganization takes place for a tax reason, the GAAR may still not apply. It is only when a reorganization is primarily for a tax purpose and is done in a manner found to circumvent a provision of the Income Tax Act that it may be found to abuse that provision. And it is only where there is a finding of abuse that the corporate reorganization may be caught by the GAAR.95

In MacDonald,96 also a surplus-stripping case, the Federal Court of Appeal overturned the Tax Court’s decision and held that subsection 84(2) applied on a technical basis; it declined to deal with the GAAR issue on the ground that it was unnecessary to do so. The GAAR issue was addressed by the Tax Court, which noted that the GAAR analysis would be complete only if it addressed the minister’s concerns about surplus stripping per se. However, the Tax Court concluded that it is doubtful

94 Copthorne, supra note 12, at paragraph 118. In Gwartz, supra note 81, at paragraphs 50-51, the Tax Court confirmed that surplus stripping does not inherently constitute abusive tax avoidance. However, in CRA document no. 2012-043261E5, June 18, 2013, the CRA stated that notwithstanding Gwartz, the CRA intends to demonstrate to the court, “at the next opportunity,” that there is an overall scheme of the Act against surplus stripping. We understand that at the 2013 Canadian Tax Foundation annual conference, the CRA confirmed that it is working on a comprehensive response to surplus stripping (broadly defined), which we understand will delineate between acceptable and unacceptable surplus stripping; however, the CRA acknowledged that it will have to bear in mind the Supreme Court’s conclusions in Copthorne.

95 Copthorne, supra note 12, at paragraph 121.

96 MacDonald v. The Queen, 2012 TCC 123; rev’d. 2013 FCA 110.
whether, in an integrated corporate-shareholder tax system, a surplus strip per se can be said to abuse the spirit and object of the Act read as a whole.97

**CONCLUSION**

As a practical matter, any GAAR issues should be analyzed and the relevant evidence gathered as early in the dispute resolution process as possible. This has the benefit of efficiency but also allows arguments to be tested and revised, and issues to be resolved, early in the process.

One reason why GAAR cases may be difficult to reconcile is that they are unavoidably a highly factual determination. The tax practitioner’s role is to ensure that the evidence and facts are properly presented to the CRA officer or the court. Despite clear statements by the courts that GAAR is not a smell test, it will be more difficult in some transactions for the trier of fact to ignore normative considerations and thus raise greater litigation and reputational risks. The jurisprudence indicates that appellate courts will usually defer to the Tax Court of Canada in GAAR cases.98

Although taxpayers are rarely successful in rebutting the existence of a tax benefit or an avoidance transaction, they should not concede these points too quickly. We believe that this will be an area of increased dispute resolution activity. Given the onus on taxpayers to rebut the minister’s assumptions, it will be important to keep evidence of intention and purpose, which can be used in rebuttal should the minister allege the existence of an avoidance transaction.

Finally, recent trends in GAAR jurisprudence indicate that courts will focus more on the specific policies relied on by the minister. Taxpayers should proactively rebut the minister’s position on the policy rationale of specific provisions. This will raise issues, certain to be litigated in the future, of permissible extrinsic evidence, access-to-information requests, and early disclosure of the minister’s views as to the policy of provisions of the Act.

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97 Ibid. (TCC), at paragraph 101.
98 Li and Hwong, supra note 20, at 364. See Canada Trustco, supra note 3, at paragraph 66:
“7. Where the Tax Court judge has proceeded on a proper construction of the provisions of the *Income Tax Act* and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.”
Policy Forum: New Zealand’s General Anti-Avoidance Rule—A Triumph of Flexibility over Certainty

Craig Elliffe*

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Introduction

The oldest general anti-avoidance rule (GAAR) in the world is a somewhat crude instrument that has been honed to a very sharp edge by the New Zealand Supreme Court. The evolution of New Zealand’s GAAR is classic evidence that, at least in New Zealand, such broadly worded anti-avoidance provisions are ultimately judge-made law. This conclusion is borne out—as this article seeks to demonstrate—by an analysis of the history of the NZ jurisprudence relating to GAAR.

The consistent problem with New Zealand’s GAAR, and perhaps any statutory GAAR, is that it is drafted too broadly to provide certainty of outcomes to taxpayers,
revenue officials, and the judiciary.1 There are, of course, reasons why the NZ Parliament drafted the rule in this way. The purpose of New Zealand’s GAAR is to anticipate and defeat the tax planning of clever people. The process of statutory interpretation of GAAR in New Zealand has been and is, fundamentally, one of judges trying to give meaning to a provision that on a literal interpretation has never made sense.2

That New Zealand’s GAAR is predominantly judge-made law also explains, insofar as it is possible to do so, how the events of the last five years have quite significantly changed and developed the tax-avoidance landscape in New Zealand. This article attempts to explain the recent experience in light of the features of New Zealand’s GAAR.

A BRIEF HISTORY

New Zealand has had a GAAR in its tax legislation since 1878,3 even before income tax was introduced.4 For much of its 136-year history, the provision remained virtually unchanged.5 In the 1960s, however, New Zealand’s commissioner of inland revenue began to litigate using GAAR. Judicial criticism of deficiencies in the terms used in the statute was common. For instance in 1971, in one of the early NZ tax-avoidance cases to reach the Privy Council, Mangin v. cir, Lord Wilberforce observed, “Originating in a desire to deal with the simple matter of incidence of land tax, [the

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1 This article focuses on the New Zealand GAAR and does not consider the definition of tax avoidance found in other, particularly Commonwealth, jurisdictions. New Zealand’s GAAR is, generally speaking, much broader in its scope and definition than the equivalent provisions enacted by other jurisdictions such as Australia, Canada, and the United Kingdom. The current version of the New Zealand GAAR is contained in part B of the Income Tax Act 2007 (herein referred to as “the ITA”).

2 See the discussion on the statutory definition of “tax avoidance” below, under the heading “The Current Statute,” and the conclusions of Michael Littlewood in his article “The Possibility of Amending New Zealand’s Anti-Avoidance Rule” (2013) 25:3 New Zealand Universities Law Review 522, at 527.

3 Section 62 of the Land Tax Act 1878 was an anti-avoidance provision designed to prevent landlords from transferring the burden of tax to their tenants.

4 With the introduction of a New Zealand income tax, GAAR was enacted as section 40 of the Land and Income Tax Assessment Act 1891.

5 Section 40 of the Land and Income Tax Assessment Act 1891 was replaced by section 82 of the Land and Income Tax Act 1900. Even as late as 1900, section 82 continued to have a carryover from section 62 of the Land Tax Act 1878 by continuing to refer to the avoidance of tax by arrangements and agreements made between landlords and tenants, between mortgagors and mortgagees, and between any other persons. It voided such “covenants or arrangements” that had the “purpose or effect of in any way directly or indirectly altering the incidence of any tax.” Section 82 was re-enacted in identical terms in the Land and Income Tax Act 1908 and then again in the Income Tax Act 1916. After 1916, section 170 of the Land and Income Tax Act 1923 and section 108 of the Land and Income Tax Act 1954 were also based on this provision.
general anti-avoidance provision] has found itself confronted, with only minor changes of language, with all the sophistications of modern tax ‘avoidance.’”

From 1916 to 1974, judges wrestled with the provision, which then read as follows:*

S 108. Every contract, agreement, or arrangement made or entered into, whether before or after commencement of this Act, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay income tax.

Every *arrangement* that has the *purpose or effect of altering the incidence* of income tax includes virtually every transaction where the hypothetical maximum amount of tax is not paid. This meant that, in theory, virtually every transaction was capable of being voided by section 108. Judges (being, on the whole, rational and intelligent) decided that the words could not mean what they said. The response was to import some limitations into section 108, which were frequently referred to as judicial glosses. These included, inter alia, the following propositions:

- Tax avoidance should be established by reference only to objective factors (overt acts and outcomes), and not subjective factors (motives and intentions).
- Transactions capable of explanation by reference to ordinary business or family dealings would not come within GAAR.

In some circumstances, though, even family or business dealings would be caught by section 108 if the purpose or effect of tax relief was pursued as a goal in itself, as opposed to arising as a natural consequence of some other business or family purpose. It was unclear exactly what family or business dealing would be immune to a GAAR attack. The statutory provision itself was criticized because “[i]t cannot be given a

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6 *Mangin v. Commissioner of Inland Revenue*, [1971] NZLR 591, at paragraph 601. The first NZ case considered by the Privy Council was actually much earlier and concerned the anti-avoidance provisions relating to death duty in the decision *Minister of Stamps v. Townend*, [1909] AC 633 (PC).

7 The provision relevant in the 1960s was section 108 of the Land and Income Tax Act 1954, which remained unchanged from 1916.

8 These propositions were espoused by New Zealand judges as a consequence of the Privy Council’s decision on the equivalent Australian GAAR provision in *Newton v. Commissioner of Taxation of the Commonwealth of Australia*, [1958] AC 450 (PC). In that case, the Privy Council proposed that a purpose of tax avoidance could be established by predication—that is, the motives of the taxpayer were irrelevant but the statutory purpose of tax avoidance was to be discerned by the taxpayer’s overt acts of implementation—and that such a tax-avoidance purpose could not be established if the actions of the taxpayer were referable to ordinary family or business dealing. Ibid., at 454-56. As a result of the second proposition, taxpayers had an automatic defence against the application of GAAR if they could establish that the transaction in question was ascribable to an ordinary family or business dealing.

literal application, that would . . . result in the avoidance of transactions which were obviously not aimed at by the section.”

The resulting confusion necessitated changes to the legislation, which were made in 1974. These changes made it clear that, first, a “tax avoidance arrangement” included an arrangement one of the purposes of which was tax avoidance (that is, tax avoidance was not a “merely incidental” purpose); and second, a “tax avoidance arrangement” could arise even where the purposes or effects of the arrangement were referable to ordinary business or family dealings. However, the amended legislation did not explain the relationship between substantive black-letter tax provisions, particularly those that expressly permitted tax concessions, and the general anti-avoidance provision.

This issue of the relationship between specific provisions and GAAR arose in a 1986 decision of the Court of Appeal. In Challenge Corporation, the majority of the court decided that a tax-paying group could purchase an unconnected company that had no assets other than a carryforward loss, and could offset that loss against other companies’ group profits, unaffected by the application of GAAR. The loss could be grouped with the profits of the other companies using a specific provision in the taxation Act. Richardson J analyzed the relationship between the specific loss offset provisions relating to group companies and GAAR, and developed what is often described as “the scheme and purpose approach” to tax-avoidance analysis. He concluded that the taxpayer’s transactions were simply tax-authorized elections and that Parliament could not have intended that GAAR would apply to deprive taxpayers of specific options available under the grouping rules. On appeal, the Privy Council

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10 Commissioner of Inland Revenue v. Gerard, [1974] 2 NZLR 279, at paragraph 280 (CA) (per McCarthy P). As a result of this and other judicial criticism, quite significant reforms occurred in 1974 (see infra note 11 and the related text).


12 For a fuller description, see the decision of the New Zealand Supreme Court in Ben Nevis Forestry v. CIR, [2008] NZSC 15. Ben Nevis is discussed in detail below.


14 Ibid., at paragraph 545. Richardson J concluded that the GAAR legislation had not defined its relationship with specific deduction provisions and that it was a task of the court to decide what was proper and improper tax avoidance.

15 Ibid., at paragraph 549, where Richardson J held, “For the enquiry is as to whether there is room in the statutory scheme for the application of s 99 in the particular case. If not, that is because the state of affairs achieved in compliance with the particular provision relied on by the taxpayer is not tax avoidance in the statutory sense. Reading s 99 in this way is to give it its true purpose and effect in the statutory scheme and so allow it to serve the purposes of the Act itself. It is not the function of s 99 to defeat other provisions of the Act or to achieve a result which is inconsistent with them [emphasis added].” Section 99 is the predecessor provision to ITA section BG 1.

16 Ibid. The other majority judge, Cooke J, agreed with this decision but on different grounds, holding that a specific anti-avoidance provision displaced the application of GAAR in this situation.
reversed the decision and applied GAAR, adopting a broader approach that considered the economic reality of the transaction and deciding against a taxpayer who sought to obtain a tax advantage without suffering an economic cost.17

Subsequent decisions in New Zealand broadly followed the scheme and purpose approach.18 This was subject to consideration of whether, on the true construction and application of the specific provision, Parliament could have intended to give the particular tax benefit claimed.

This brings us to more recent events and the decisions of the New Zealand Supreme Court in late 2008. The court, concerned with “continuing uncertainty about the interrelationship of the general anti-avoidance provision with specific provisions,” set out to “settle the approach which should be applied in New Zealand.”19

THE CURRENT LAW AS SET OUT IN BEN NEVIS

Before I discuss the crucial Supreme Court decision in Ben Nevis, a brief description of the background facts may be helpful.20

The tax-avoidance issue in Ben Nevis arose from “the Trinity scheme,” New Zealand’s largest tax-planning scheme to date, involving a potential $3 billion of deductions. The underlying investment was the development of a Douglas fir forest, which would be ready for harvest by 2048. Essentially, the scheme was designed to work as follows:

- The taxpayers undertook to pay an inflated licensing fee in 2047 for use of the forestry land.
- The taxpayers also entered into a captive insurance arrangement to ensure that, if the net proceeds from the sale of the harvested trees were not sufficient to fund the payment of the licensing premium in 2048, the investors could still meet the payment.
- The bulk of the licence and insurance premium payment obligations were satisfied by the issuance of promissory notes by the taxpayers, so that, for an annual cash outlay of $50 per hectare, each taxpayer could obtain annual tax deductions of approximately $41,000 per hectare.

The High Court and the Court of Appeal both found in favour of the commissioner of inland revenue, agreeing that the scheme was a tax-avoidance arrangement.

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18 See Commissioner of Inland Revenue v. BNZ Investments Ltd., [2002] 1 NZLR 450 (CA), and Peterson v. Commissioner of Inland Revenue, [2006] 3 NZLR 433 (PC). An outlier decision is that of the Privy Council in Commissioner of Inland Revenue v. Auckland Harbour Board, [2001] 3 NZLR 17,008, where significantly less emphasis was placed on the application of GAAR.
19 Ben Nevis, supra note 12, at paragraph 100.
The taxpayers appealed to the Supreme Court, which also agreed that the arrangement crossed the line of acceptable tax planning.\(^{21}\) Although the decision concerned the Income Tax Act 1994, there is no material difference in the current 2007 statute (the ITA).\(^{22}\)

**The Current Statute**

Part B of the ITA provides, under the heading “Overriding effect of certain matters,” that “the Commissioner may counteract a tax advantage from a tax avoidance arrangement.”\(^{23}\) Subpart BG deals with tax avoidance and simply states that “a tax avoidance arrangement is void as against the Commissioner for income tax purposes.”\(^{24}\)

Therefore, a key definition is the meaning of “tax avoidance arrangement.”\(^{25}\)

That definition reads as follows:

\[\ldots\text{ an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—}\]

\[\text{(a) has tax avoidance as its purpose or effect; or}\]

\[\text{(b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental.}\]

It is unusual (though quite possible) to have an arrangement that has tax avoidance as its sole purpose or effect.\(^{27}\) Much more common is a commercial transaction that has a tax-avoidance purpose or effect as one of its purposes or effects.\(^{28}\) What, then, is the meaning of “tax avoidance”? The ITA defines “tax avoidance” to include

\[\text{(a) directly or indirectly altering the incidence of any income tax;}\]

\[\text{(b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax.}\]

\(^{21}\) For a full analysis of the Supreme Court’s reasoning, see Elliffe and Keating, ibid.

\(^{22}\) Supra note 1.

\(^{23}\) ITA section BB 3 (1).

\(^{24}\) ITA section BG 1 (1).

\(^{25}\) In my view, a much less important definition is that of an “arrangement,” which is found in ITA section YA 1 and is of such a broad and all-encompassing nature that it is difficult to think of any form of transaction, plan, or loose understanding that would fall outside its scope.

\(^{26}\) ITA section YA 1.

\(^{27}\) Oddly enough, some transactions that have tax avoidance as a sole purpose—for example, an investment in a portfolio investment entity deposit account—have been held by the Supreme Court not to be a tax-avoidance arrangement. The Supreme Court in *Penny and Hooper v. Commissioner of Inland Revenue*, [2011] NZSC 95, at paragraph 49, suggested that sometimes Parliament contemplates that a tax provision can be used deliberately to obtain a tax advantage.

\(^{28}\) The statutory definition of “tax avoidance arrangement” has the effect of narrowing the statutory definition of “tax avoidance,” in particular by introducing the concept of taking outside that definition those transactions that only have a “merely incidental” tax-avoidance purpose.
(c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax.29

The statutory definition of “tax avoidance” is problematic for the following reasons:

- First, it refers to “altering the incidence of any income tax.” This is the same complication referred to above in discussing section 108 of the 1954 Act. Any modification to a transaction that results in a tax saving from a hypothetical maximum can potentially cause the transaction to be caught as tax avoidance, no matter how commercially valid the transaction may be. For example, take a sole trader who pays tax at 33 percent30 and decides to incorporate his or her business. Read literally, GAAR would apply to the commercial use of a corporate entity in New Zealand, which pays tax at 28 percent,31 since the process of transferring the business from an individual to a lower-rate taxpayer wholly owned by the individual (or his or her associates) would always be an example of altering the incidence of tax.32 That proposition is clearly untenable, although there will be some circumstances where the transaction or structure adopted would be captured by GAAR.33

- Second, characterizing as tax avoidance a transaction that has the effect of relieving a person from potential or prospective liability to future income tax produces even more bizarre outcomes. Such a broad application would catch, for instance, the sale of income-producing assets, the decision to undertake various investments34 (in terms of both income-producing yield versus capital growth and the location of the investments), employment and career decisions, and decisions as to residence. This must be why Michael Littlewood suggests

29 ITA section YA 1.

30 The current maximum individual rate for NZ taxpayers.

31 The corporate rate of tax.

32 A consequence of such an approach is that, for tax reasons, business people who began as sole traders would have to remain so for the entire duration of the business, irrespective of creditor-protection concerns or commercial convention and desirability.

33 The incorporation of a sole trader offends against the definition of tax avoidance because in such cases, first, one or more taxpayers alter the incidence of their tax liabilities, and second, the change in entity results in a change of tax incidence. This is not to say that in some circumstances the decision to incorporate a business is not tax avoidance. The payment of a non-market salary by orthopaedic surgeons after they had transferred their business to a corporate entity constituted tax avoidance in the Supreme Court decision in Penny and Hooper, supra note 27. The key issue in that case, however, was not the use of a corporate structure but rather the non-market salary paid to the orthopaedic surgeon.

34 For example, an avoidance transaction could arise if a taxpayer withdrew money from a term deposit yielding 8 percent to make a residential property investment with a negative income return and an expected tax-free capital gain, or, alternatively, to make an overseas share investment.
that “to define tax avoidance as meaning any act that reduces a person’s liability to tax would produce absurd results.”35

The Approach of the Supreme Court

Given the above comments about both the historical and the current statute, it is no surprise that the Supreme Court in Ben Nevis spent little time in trying to analyze the definitions of “tax avoidance” and “tax avoidance arrangement.” The court reflected that, in its view, Parliament had deliberately chosen to leave to the judiciary the job of working out the kind of arrangements that are caught by GAAR.36 This feature of the NZ GAAR jurisprudence has been noted by the inland revenue commissioner in her recent interpretation statement:

The Commissioner’s view is that Parliament’s purpose in enacting the definition of “tax avoidance” was to confirm or clarify that certain circumstances will constitute tax avoidance, rather than to provide a comprehensive definition of what constitutes tax avoidance. This is supported by the fact that, in establishing whether there is tax avoidance, the courts (including the Supreme Court in Ben Nevis) have typically come to a conclusion without embarking on any detailed analysis of the statutory definition of “tax avoidance” and, at times, have not referred to the definition at all.37

In Ben Nevis, the Supreme Court referred to the definition of “tax avoidance” but performed no analysis of the statutory definition.38 Instead, the court did the only sensible thing it could do, given the breadth of the definition, and set out to give its own meaning to the provision. It did so by creating the parliamentary contemplation test.

35 Littlewood, supra note 2, at 527.
36 Ben Nevis, supra note 12, at paragraph 101.
38 This approach of not undertaking a detailed analysis of the GAAR statute is consistent with decisions of the NZ courts both pre- and post-Ben Nevis. This is noted by the commissioner in her interpretation statement, supra note 37, at paragraphs 154 and 157. Pre-Ben Nevis, neither the Privy Council in Miller v. Commissioner of Inland Revenue, [2001] 3 NZLR 316, and Peterson, supra note 18, nor the New Zealand Court of Appeal in Dandelion Investments Limited v. Commissioner of Inland Revenue, [2003] 1 NZLR 600, did so. Post-Ben Nevis, the statutory definition is not regarded as being important in the Supreme Court decision in Penny and Hooper, supra note 27, and also does not feature in the High Court decisions in Westpac Banking Corp. v. Commissioner of Inland Revenue (2009), 24 NZTC 23,834 (HC); BNZ Investments, supra note 18; and White v. Commissioner of Inland Revenue (2010), 24 NZTC 24,600 (HC).
The Judicial Meaning of Tax Avoidance—
The Parliamentary Contemplation Test

The parliamentary contemplation test involves a two-step analysis, which the Supreme Court described at some length and summarized as follows:

The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament’s purpose.39

The first step in the analysis is to identify Parliament’s purpose in enacting the relevant provision (or possibly a combination of provisions). In the Supreme Court’s words, “[t]he taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope.”40 The inquiry is therefore focused on what outcome Parliament intended for the provision or provisions.41 This may be ascertained through the process of statutory interpretation, necessarily considering the meaning and context of the provision(s), together with the legislative history. But reference may also be had, of course, to case law, and perhaps to relevant extrinsic material, particularly to confirm a decision based on the analysis of the relevant provisions.42

The second step requires an analysis of the commercial reality and economic effects of the arrangement. This involves an examination of “the taxpayer’s use of the specific provision viewed in the light of the arrangement as a whole.”43 It seems clear from the decision in Ben Nevis that this test empowers the commissioner and the courts to look behind the transaction in order to understand what is truly going on. For instance, is the expenditure truly being borne (that is, is the economic burden really sustained by the payer)? Or is the expectation that the resultant loan will not be repaid; or, if it is repaid, does this occur out of self-generated and inflated profits derived from a circular transaction?

In order to determine the commercial reality and economic effects of an arrangement, the Supreme Court highlighted a number of “relevant factors” that could be considered.44 These include

39 Ben Nevis, supra note 12, at paragraph 109.
40 Ibid., at paragraph 107.
41 Ibid.: “If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement [emphasis added].”
42 Interpretation Statement, supra note 37, at paragraphs 226-234.
43 Ben Nevis, supra note 12, at paragraph 107.
44 Ibid., at paragraph 108.
The manner in which the arrangement is carried out. . . . [T]he role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions. . . . [T]he duration of the arrangement and the nature and extent of the financial consequences [and the structure or nature] of an arrangement [if it is carried out] in an artificial or contrived way.45

The commissioner makes the point in her interpretation statement that the second step of ascertaining commercial reality and economic consequences may inform the analyzer about Parliament’s purpose in the context of the particular arrangement.46 Consequently, steps one and two may be an iterative process.

Finally, if it is determined, as a result of the parliamentary contemplation test, that the arrangement has tax avoidance as a purpose or effect, it is then necessary to examine whether that tax-avoidance purpose is merely incidental. The Supreme Court in Ben Nevis was very brief on the role of the “merely incidental” test, noting that

it will rarely be the case that the use of a specific provision in a manner which is outside parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental.47

The commissioner, relying on dicta from the Supreme Court decision in Penny and Hooper,48 will apply the merely incidental test by examining non-tax-avoidance purposes, in order to determine whether the tax-avoidance purpose or effect follows from, or is concomitantly linked to, without contrivance, those other commercial and private purposes or effects.49

THE IMPLICATIONS OF A BROAD GAAR
AND ROBUST LITIGATION

There is no criticism of the judiciary in all of this, because they have been doing the best that they can to discern where to draw the line on impermissible tax avoidance, given the breadth of the meaning of tax avoidance in the statute. They have been doing an exercise in statutory interpretation that, from necessity, has placed a heavy emphasis on the word “interpretation” and precious little on the word “statutory.” “What Parliament contemplates” is a judge-made test simply because the Supreme Court had to devise a mechanism to guide taxpayers, tax administrators, and the lower
courts; the court could not rely on guidance from the statute itself; and the court wanted to resolve 50 years of confusing case law.

Parliament wants specific tax provisions to work, but it does not want them to be abused, either in isolation or in combination. To achieve the desired balance, the relation between GAAR and specific provisions is resolved by interpreting them as provisions that are “meant to work in tandem.”50 Under a purposive interpretation, given that GAAR is the principal vehicle to address tax avoidance, Parliament applies GAAR in circumstances where a specific provision is being used in a way that Parliament would not have contemplated.51 This tandem approach, together with the second step of the parliamentary contemplation test, gives the court greater scope to examine the economic substance of what has really occurred in a particular transaction.

The flaw in the Ben Nevis decision, and in most other decisions relating to GAAR, is the absence of an analysis of the statute itself, for the reasons previously discussed. Perhaps recent judges should have been more critical and strident in expressing dissatisfaction with the provision.52 That said, the courts seem to be doing a much more complete job than Parliament, in accordance with Parliament’s general directives to them.

**Flexibility**

The progression from the predication test to the scheme and purpose analysis, and now to parliamentary contemplation, indicates significant flexibility in the judicial approach. Several developments in the Ben Nevis case illustrate this point.

My view, which is shared by others,53 is that, with the decision in Ben Nevis, the Supreme Court has successfully refined and developed GAAR jurisprudence: first, by more clearly defining the relationship between GAAR and the interpretation of specific tax provisions (the so-called tandem approach); and second, by proposing an analysis that involves an inquiry into the commercial and economic reality of transactions and the use of specific tax provisions seen through the lens of how Parliament intended the provisions to be used (the second step of the parliamentary contemplation test).

The tandem approach to interpreting the specific provisions and GAAR represents a subtle change in emphasis from the previous scheme and purpose test. This is the

50 Ben Nevis, supra note 12, at paragraph 103.
51 Ibid., at paragraph 104.
52 See Lord Wilberforce’s criticism of the GAAR provision in Mangin, supra note 6.
view of Supreme Court Justice Susan Glazebrook, speaking extrajudicially. In a recent conference paper, she noted with interest that in the Court of Appeal decision in Challenge, the majority (who decided in favour of the taxpayer) had considered the role of the specific provisions prior to considering GAAR. This approach could be distinguished from that of the minority, who considered the anti-avoidance provisions first. Her Honour speculated that the tandem approach may change the outcome in the decision-making process.

Justice Glazebrook also considered that a greater emphasis on the commercial and economic consequences of the wider transaction, which is the second step of the parliamentary contemplation test, may also, arguably, contribute to this change in emphasis. She highlighted consideration of the existence of non-market transactions in recent decisions such as Glenbarrow and Penny and Hooper, representing a change from the approach taken by the court in Europa and Peterson. (In these earlier Privy Council cases, a majority of the panel had accepted the deductibility of expenditures on the basis of the legal instruments entered into, without undertaking a significant inquiry into the underlying economics of the transaction.)

This ability to formulate new approaches, whether they are described as subtle or as a sea change, is nonetheless a change that authorizes judges to conduct a closer examination of the commercial and economic consequences of transactions. This is clearly a desirable development in tax-avoidance jurisprudence from a broader societal perspective.

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55 Challenge, supra note 13.

56 Ibid. Richardson J and Cooke J started with the loss offset provision prior to examining the role of GAAR.

57 Ibid. In the minority decision, Woodhouse P started with the anti-avoidance provision and held that GAAR did apply.

58 Glazebrook, supra note 54. Justice Glazebrook noted that this wider view, considering the economic effects of transactions, was arguably similar to the approach of the Privy Council in Challenge, supra note 17.

59 Glenbarrow Holdings Ltd. v. Commissioner of Inland Revenue (2009), 24 NZTC 23,236 (SC).

60 Penny and Hooper, supra note 27.


62 Peterson, supra note 18.

63 Another alternative view is that the Ben Nevis decision marks a return to jurisprudential tax-avoidance orthodoxy after the approach of the Privy Council in Peterson, and in Auckland Harbour Board, supra note 18, which might be viewed as a high watermark of form over substance.

64 Provided that one thinks that the prevention of tax avoidance should be facilitated.
Certainty

The disadvantage of flexibility is lack of certainty, and lack of certainty is undesirable for commerce. The position of the Supreme Court on this point, however, is clear: “The courts should not strive to create greater certainty than Parliament has chosen to provide.”

Recent cases in New Zealand have created quite a furor because the line between legitimate tax planning and tax avoidance was either mistaken by taxpayers and their advisers or redefined by the first GAAR cases heard in the New Zealand Supreme Court. It is contended that the approach taken by the Supreme Court, and its subsequent application in the High Court and the Court of Appeal, surprised those closely involved in taxation.

In support of this contention, one can point to the reaction of taxpayers and their advisers to the *Ben Nevis* decision. Three influential taxation groups, concerned about developments in anti-avoidance, prepared a report on improving the operation of New Zealand’s tax-avoidance laws. This report made suggestions for legislative reform and other changes to the tax administration process with respect to the operation of GAAR. The report, written in 2011, stated:

> Until three or four years ago, it was generally understood that commonplace arrangements which resulted in tax savings should not be subject to the GAAR. The basis for this understanding is best captured by the following passage in the Australian Tax Office statement summarising the principles of Australia’s GAAR:

> It is reasonable to assume that the tax opportunities of straightforward dealing have been considered by those who design tax laws, and having been considered, if not then prevented, have in effect been implicitly sanctioned.

> Most tax specialists would agree that the statement no longer reflects Inland Revenue’s practice in New Zealand. Nor does it reflect the approach being taken by at least some High Court and appellate court judges.

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65 *Ben Nevis*, supra note 12, at paragraph 112.

66 *Ben Nevis*, ibid., and *Glenharrow Holdings*, supra note 59.

67 In particular, the structured finance cases heard in the Auckland and Wellington High Courts in *Westpac* and *BNZ Investments*, supra note 38.


69 Rather than the outcome of the cases themselves, both of which seem to involve rather egregious and heavily tax-influenced transactions to which GAAR should apply.


72 Supra note 70, at 354-55.
It was not only tax advisers and taxpayers who were caught like possums in the headlights. According to the report, different divisions of Inland Revenue took different views on the application of GAAR. Taxpayers who had received a favourable ruling on one particular transaction could not rely on it in respect of other similar or virtually identical transactions where different Inland Revenue personnel were assessing the tax outcome.\footnote{\textit{Westpac}, supra note 38. The court stated, at paragraph 29, “On the other hand, there plainly was a difference in approach between the two business units [within Inland Revenue]. At a broad level, Corporate staff were generally far more sceptical of the repo deals than Rulings had been in relation to the First Data transaction. As well, Corporate took a more bullish (or perhaps aggressive) approach to the application (and scope) of s BG 1.”}

Major NZ corporate taxpayers who had entered into very significant transactions were suddenly on the front page of the business papers, being accused of tax avoidance. These corporations were advised by the best tax lawyers and accountants, yet the tax position they had taken ultimately seemed untenable in light of the new case law. As a result, New Zealand saw a high level of litigation involving complex billion-dollar transactions in the so-called structured finance cases.\footnote{The tax position taken in the structured finance cases and the litigation commenced prior to the decision in \textit{Ben Nevis}, supra note 12.} Two such cases, \textit{Westpac} and \textit{BNZ Investments},\footnote{\textit{Westpac}, supra note 38, and \textit{BNZ Investments Limited v. CIR} (2009), 24 NZTC 23, 582.} were decided in favour of the commissioner at the High Court level and subsequently settled by the parties.

The change in approach affected smaller taxpayers as well as multinationals. For example, the \textit{Penny and Hooper} case,\footnote{\textit{Penny and Hooper}, supra note 27.} involving the diversion of personal services income using interposed entities to derive income, applied to small and medium-sized businesses but affected a significantly larger group of taxpayers than did the structured finance cases.

Lack of certainty for taxpayers continues as more litigation regarding various forms of hybrid instruments used in cross-border funding is currently being progressed. In early 2014, the Supreme Court will hear an appeal of the \textit{Alesco} case\footnote{\textit{Alesco}, supra note 68.} relating to the use of optional convertible notes (OCNs). In that case, the Court of Appeal decided that the transactions constituted a tax-avoidance arrangement.

A number of commentators have expressed concern about the impact on business caused by lack of certainty. For example, Kirsty Keating, a New Zealand-based tax partner with Ernst & Young has pointed out:

\begin{quote}
While uncertainty is inherent in the application of general anti-avoidance provisions, the current lack of guidance is causing real problems both to the taxpayers and potentially for the New Zealand economy as a whole. A number of large taxpayers are beginning
\end{quote}
to ask whether it is worth remaining in New Zealand given the tax uncertainty they face when planning investment in structural choices in this country.78

Clearly, if multinational businesses rely on unintended tax advantages relating to tax avoidance to justify investment in a country, such investment may not be desirable. But there is a valid concern if the tax system is seen as an impediment to mainstream (rather than tax-driven) commercial transactions and foreign investment. This seems to be a widely held view in the private sector, but it is very difficult to validate except by anecdotal experience.

**Integrity of the System**

New Zealand is extremely lucky to have, on the whole, both a clear-headed judiciary and a responsible tax administration, because a relatively unfettered discretion in the use of GAAR can make the conduct of commerce difficult. Less scrupulous regimes would make the existence of such a broad GAAR impossible because of the risk that the administration might abuse its power. There is still a concern in New Zealand that GAAR may be used to make retrospective changes to deficient legislation.

Inland Revenue released its 133-page interpretation statement in June 2013.79 The document is a comprehensive and constructive analysis of considerable merit. The commissioner provides assurance that she exercises great care in the application of GAAR, noting that Inland Revenue has a centralized system that carefully controls and authorizes its use.

One point also requires further clarification in the courts, because there is inconsistency. It relates to the use of objective and subjective evidence. The Supreme Court, seeking a principled approach that would give greater certainty, reinforced that an NZ court should focus “objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up.”80 The court has thus clarified that one aspect of Lord Denning’s famous predication test in *Newton*81 is alive and well: In determining the purpose or effect of an arrangement, what is assessed as a matter of evidence is the actions of the taxpayer, rather than subjective comments.82

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79 Interpretation Statement, supra note 37.

80 Ibid., at 102. Despite the clear authority that the purpose or effect of the arrangement should be determined objectively, in *Alesco*, supra note 68, the commissioner advanced documents generated by the taxpayer and its tax advisers that refer to the tax savings available under the OCN arrangement as proof of its tax-avoidance purpose.

81 *Newton*, supra note 8, at 454-56.

82 This is in contrast to the other aspect of Lord Denning’s test, which exonerated family and business dealings from the application of GAAR and which the 1974 statute repealed. Ibid.
This component of the predication test is not to be confused with the second step of the parliamentary contemplation test. The latter seems to require an examination of the arrangement in a commercial and realistic way, and may involve looking at a taxpayer’s—or an adviser’s—subjective comments. If the court wishes to make selective use of subjective or objective evidence to achieve different aims, this should be made clear.

A real problem exists in respect of GAAR and its administration. Since 1996, New Zealand has operated a civil penalties regime (known as “shortfall penalties”) to deter and punish taxpayers for their non-compliance.83 Taxpayers who engage in tax avoidance may be liable for the imposition of the shortfall penalty for taking an “abusive tax position,”84 calculated at 100 percent of the tax underpayment resulting from their avoidance.85 The penalty may be imposed when the taxpayer has both taken an unacceptable tax position and done so with a dominant purpose of avoiding tax. However, the assessment of that penalty on tax avoiders is far from certain.86

The first requirement before the penalty can be imposed is that the taxpayer’s argument fails to meet the standard of “about as likely as not to be correct.”87 This has been interpreted to mean that the taxpayer needs to have a reasonable and credible argument to support its position, even if that position is not necessarily correct.88 Thus, the court may find that a taxpayer has committed tax avoidance but nevertheless still had a reasonable argument, and therefore the shortfall penalty will not apply. This approach ensures that the penalty applies to only the most egregious instances of tax avoidance—avoidance that is abusive, and as such is deserving of a significant penalty.

Significantly, the legal merits of the arrangement must be determined at the time that the taxpayer’s position is taken (that is, when the return is filed), not when the court comes to consider that position years later.89 So the question must be whether the taxpayer’s position, at the time taken, was one that was obviously incorrect, rather than one that subsequently turns out to be wrong.

If the hypothesis in this article is correct, and the test of tax avoidance has changed over time, then careful attention needs to be paid to the applicable case law

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83 Tax Administration Act 1994, section 139.
84 Ibid., section 141D.
85 See Ben Nevis, supra note 12, particularly the discussion at paragraphs 177-178 regarding the rationale for imposing such a penalty for tax avoidance.
86 The penalty was not imposed in a number of tax-avoidance cases, including Glenbarrow, supra note 59, and Penny and Hooper, supra note 27.
87 Tax Administration Act 1994, section 141B.
88 Ben Nevis, supra note 12, at paragraph 184: “On its terms this standard does not require that the appellants’ tax position had a 50 per cent prospect of success but, subject to that qualification, the merits of the arguments supporting the taxpayer’s interpretation must be substantial.”
89 Tax Administration Act 1994, section 141B (6).
at the time the tax position was taken. Recent decisions, such as the Alesco decision in the Court of Appeal, have been criticized because penalties have been imposed without sufficient analysis of the state of the law at the time the transaction was entered into.90

CONCLUSION

The last five years, post-Ben Nevis, have seen significant changes in the operation of New Zealand’s GAAR. The uncertainty and disruption caused by litigation in this recent period will, in time, be forgotten.

Few would argue that GAAR, as it is currently being applied, is not effective in preventing tax avoidance. It is even effective in proscribing interest expense incurred in cross-border hybrid instrument funding.91 The underlying reason for this is, paradoxically, the lack of precision in the definition of “tax avoidance” and the consequential need for the judiciary in New Zealand to formulate and develop principles and more detailed tests to counter tax avoidance. Perversely, the breadth of New Zealand’s GAAR is a design feature of significant value.

In Glenbarrow, the Supreme Court reflected that when Parliament enacts a measure such as a general anti-avoidance provision, the benefit of the tax statute’s ability to anticipate and deal with tax avoidance is traded off against certainty:

There will also inevitably be uncertainty whenever a taxing statute contains a general anti-avoidance provision intended to deal with and counteract such artificially favourable transactions. It is simply not possible to meet the objectives of the general anti-avoidance provision by the use, for example, of precise definitions, as may be able to be done where an anti-avoidance provision is directed at a specified type of transaction.92

The significant advantage of judicial flexibility found in the NZ system does come at a cost. It remains to be seen whether New Zealand’s approach—one that effectively asks the courts to periodically draw the line in fact-specific situations—is superior to that of other jurisdictions that attempt a more detailed statutory definition.

Meanwhile, the NZ statute is likely to remain unchanged since there is no appetite to amend it. Maybe that is a good thing. This is not because uncertainty is desirable but because the New Zealand Supreme Court has been able to successfully


91 The decision in Alesco, supra note 68, proceeds on appeal to the Supreme Court early in 2014. New Zealand's GAAR could therefore be seen as an important mechanism to prevent base erosion and profit shifting, in the sense of addressing several of the problem areas identified by the OECD in its 15-point action plan: Organisation for Economic Co-operation and Development, Action Plan on Base Erosion and Profit Shifting (Paris: OECD, 2013).

92 Glenbarrow Holdings, supra note 59, at paragraph 48.
develop key tests and provide guidance. On the basis of the 136-year history of New Zealand’s GAAR, one could expect the judiciary to further refine the parliamentary contemplation test into yet another approach.93 The overall experience with GAAR in New Zealand suggests that flexibility is viewed as more desirable than certainty—a perspective that is obviously better for tax administrators than for tax advisers and their clients.

93 In the way that the common law develops as different judges respond to different fact situations.
Douglas J. Sherbaniuk
Distinguished Writing Award

DAVID JACYK

David Jacyk is the 2013 recipient of the Canadian Tax Foundation’s Douglas J. Sherbaniuk Distinguished Writing Award. His article, “The Jurisdiction of the Tax Court: A Tax Practitioner’s Guide to the Jurisdictional Galaxy of Constitutional Challenges,” was published in (2012) 60:1 Canadian Tax Journal 55-92. The article was selected by a committee of experienced tax professionals as the best writing published by the Foundation in 2012-13. The award, which is conferred annually, is named for the Foundation’s late director emeritus.

David Jacyk received his BA and LLB degrees from the University of Manitoba and his LLM degree from the University of British Columbia. He is currently General Counsel with the Department of Justice Canada in Vancouver.
Prix d’excellence en rédaction
Douglas J. Sherbaniuk

DAVID JACYK


David Jacyk a obtenu un baccalauréat ès arts et un baccalauréat en droit de l’Université du Manitoba et une maîtrise en droit de l’Université de la Colombie-Britannique. Il occupe actuellement le poste d’avocat général au ministère de la Justice à Vancouver.
Canadian Tax Foundation Regional Student-Paper Awards

Each year, the Canadian Tax Foundation awards up to four regional student-paper prizes. Depending on the merit of the papers received, one prize may be awarded for each of four regions of the country: Atlantic Canada (the Canadian Tax Foundation-McInnes Cooper Award); Quebec (the Canadian Tax Foundation-Jean Potvin Award); Ontario (the Canadian Tax Foundation-Fasken Martineau DuMoulin Award); and western Canada (the Canadian Tax Foundation-Bert Wolfe Nitikman Foundation Award). Papers must be written as a requirement of a tax-related course, including directed research courses, and can address any aspect of the Canadian tax system, including comparative analyses, tax policy, tax compliance, tax planning, and tax system design. Papers may be written in either English or French and must be recommended for award consideration by the professor or instructor of the course.

Papers will be reviewed by three independent reviewers, and abstracts (of 400 words or less) of the award-winning papers will be published in the Canadian Tax Journal. The authors of the winning papers will also receive a cash prize from the firms or institutions sponsoring the awards and a one-year membership in the Foundation, entitling them to receive complimentary copies of many of the currently issued Foundation publications, including the Canadian Tax Journal, Canadian Tax Highlights, Tax for the Owner-Manager, and the annual tax conference report, along with one year of complimentary access to TaxFind, the Foundation’s online research database. As members of the Foundation, winners can also take advantage of generous discounts on other publications as well as discounted registration fees for Foundation conferences and courses.

Submissions to the student-paper competition should be addressed to the Canadian Tax Foundation, Student-Paper Competition, 595 Bay Street, Suite 1200, Toronto, ON M5G 2N5, or e-mailed to CTF_Awards@ctf.ca. Entries must be accompanied by a letter of recommendation from the professor or instructor of the tax course for which the paper was written and must include the student’s name, address, telephone number, and e-mail address. The submission deadline for the 2013-14 academic year is June 30, 2014.
THE CANADIAN TAX FOUNDATION-FASKEN MARTINEAU DUMOULIN AWARD FOR ONTARIO

Jason T. Kujath (2012-13 recipient)

The Canadian Tax Foundation is pleased to announce that Jason T. Kujath is the winner of the Canadian Tax Foundation-Fasken Martineau DuMoulin Award for the best Ontario student paper of 2012-13 dealing with an aspect of Canadian taxation.

Mr. Kujath’s paper, “Canada v GlaxoSmithKline: Should We Modify the Arm’s Length Principle?” was written for the Juris Doctor program at the University of Windsor. Mr. Kujath graduated from the Juris Doctor program at the University of Windsor, Faculty of Law, and holds a Bachelor of Commerce degree in finance. He is currently completing his articles at Felesky Flynn LLP in Calgary.

ABSTRACT

The author provides a review and commentary on the first transfer-pricing case heard by the Supreme Court of Canada. He discusses the handling of transfer prices as applied by the Canada Revenue Agency (CRA) and the Canada Border Services Agency (CBSA).

The paper addresses the Supreme Court’s guidance on the proper valuation and assessment of transfer prices. The author opines that the court did not provide a complete approach for a proper assessment of the remitted goods’ valuation. He argues that appropriate guidance should specify the breadth of the circumstances considered under subsection 69(2)’s hypothetical inquiry; instead, the court concluded that the “business reality” should be considered.

The author also provides a critical analysis of the arm’s-length standard and highlights four considerations:

1. the arm’s-length principle in relation to its subjective application;
2. a review of the subjective circumstances that should be considered when the arm’s-length principle is applied to the commercial transactions of multinational entities;
3. the competing interests of the CRA and the CBSA; and
4. the international economic competitiveness of the jurisdiction.
THE CANADIAN TAX FOUNDATION-JEAN POTVIN AWARD FOR QUEBEC

Antoine Desroches (2012-13 recipient)

The Canadian Tax Foundation is pleased to announce that Antoine Desroches is the winner of the Canadian Tax Foundation-Jean Potvin Award for the best Quebec student paper of 2012-13 dealing with an aspect of Canadian taxation.

Mr. Desroches’s paper, “A Comparative Study of the Canadian and European Taxation of Intellectual Property Income: Has the Time Come for a Canadian Patent Box?” was written for the Master of Law program, Taxation option, at HEC Montreal, for which he received both an excellence mention and the Ernst & Young and HEC Foundation prizes. Mr. Desroches also obtained a Bachelor of Commerce degree from McGill University in 2005 and a Bachelor of Laws degree from the University of Montreal in 2008. He has practised tax law at Norton Rose Fulbright since his admission to the Quebec bar in 2010.

Abstract

Canada is recognized worldwide for its generous research and development (R & D) regime, which aims to stimulate economic benefits and spillovers as well as tax revenues from intellectual property (IP). However, the regime’s tax policy objectives are not fully achieved. Indeed, there is an exodus of IP developed in Canada—in particular, patents and software copyrights—to jurisdictions where IP income is taxed at lower rates. Therefore, those jurisdictions benefit from tax revenues related to IP developed in Canada and often largely financed through its R & D regime. Essentially, Canada is buying R & D jobs without recovering the long-term economic benefits created by those jobs.

Faced with a similar situation, some countries have adopted a tax regime known as a patent box. This regime, which is favourable to IP holdings, is generally implemented in addition to an R & D regime in order to spur innovation.

The author analyzes the tax structures implemented by multinational enterprises to export and exploit IP without being subject to Canadian tax in the long run, as well as the technical features and the surrounding tax policy of foreign patent boxes. He also considers the opportunity for Canada to adopt such a regime, which, together with its R & D regime, would provide a significant incentive to multinational enterprises not only to develop IP but also to hold it in Canada.
THE CANADIAN TAX FOUNDATION-BERT WOLFE NITIKMAN FOUNDATION AWARD FOR THE WESTERN PROVINCES

Patrick Beatty (2012-13 recipient)

The Canadian Tax Foundation is pleased to announce that Patrick Beatty is the winner of the Canadian Tax Foundation-Bert Wolfe Nitikman Foundation Award for the best western provinces student paper of 2012-13 dealing with an aspect of Canadian taxation.

Mr. Beatty’s paper, “When Politics and Economics Collide: Policy Implications for Reforming Oil and Gas Royalties,” was written for the Capstone research project at the School of Public Policy, University of Calgary. Mr. Beatty received his Master of Public Policy degree from the University of Calgary, where he was awarded the Jack and Eleanor Mintz Graduate Scholarship in Tax Policy. Mr. Beatty is a government relations adviser at Suncor Energy, Calgary.

ABSTRACT

Rising oil and gas prices have encouraged governments to increase their revenue from oil and gas development. In the last decade, both Alaska and Alberta updated their fiscal regimes to ensure that they received their “fair share” from petroleum projects. The fiscal changes implemented in both jurisdictions have proved to be extremely controversial and have provoked a strong debate over the best royalty design. In North America, the debate over fiscal regimes is often too politically charged to take account of the economics behind the achievement of the most efficient regime. The author argues that the political debate over oil and gas fiscal regimes does not reflect the economics of efficient oil and gas taxation. To make this case, he examines the economics of oil and gas royalties and the politics surrounding the fiscal changes in Alaska and Alberta. The political experience in both jurisdictions is illuminating: Alaska and Alberta share many similarities and offer excellent case studies of how royalty changes occur. The author concludes by providing some insight into how politics and economics have collided to produce less than efficient results.
Prix régionaux du meilleur article par un étudiant de la Fondation canadienne de fiscalité

Chaque année, la Fondation canadienne de fiscalité (FCF) décerne jusqu’à quatre prix régionaux pour des articles rédigés par des étudiants. Selon la qualité des articles qui ont été soumis, un prix peut être décerné pour chacune des quatre régions du pays : le Canada atlantique (le Prix FCF-McInnes Cooper); le Québec (le Prix FCF-Jean Potvin); l’Ontario (le Prix FCF-Fasken Martineau DuMoulin); et l’Ouest canadien (le Prix FCF-Bert Wolfe Nitikman Foundation). Les articles doivent avoir été rédigés dans le cadre d’un cours lié à la fiscalité, comprenant les cours de travaux dirigés, et ils peuvent porter sur tout aspect du régime fiscal canadien, y compris les analyses comparatives, la politique fiscale, l’observation des règles fiscales, la planification fiscale et la conception du régime fiscal. Les articles peuvent être rédigés en anglais ou en français et une lettre de recommandation du professeur ou du chargé d’enseignement du cours doit être au dossier.

Les articles sont évalués par trois examinateurs indépendants, et des précis (de 400 mots ou moins) des articles primés seront publiés dans la Revue fiscale canadienne. Les auteurs des articles primés recevront aussi une récompense en argent des organismes ou des sociétés qui commanditent le prix ainsi qu’une adhésion d’une année à la FCF, leur donnant le droit de recevoir des exemplaires gratuits d’un grand nombre d’ouvrages publiés par la FCF, dont la Revue fiscale canadienne, les Faits saillants en fiscalité canadienne, Actualités fiscales pour les propriétaires exploitants, ainsi que le Rapport de la conférence annuelle en fiscalité, avec un accès annuel à TaxFind en ligne, l’outil de recherche électronique de données de la FCF. À titre de membre de la FCF, les lauréats bénéficient également de réductions appréciables sur le prix d’autres publications ainsi que de frais d’inscription réduits pour les conférences et les cours offerts par la FCF.

Les dossiers de participation au concours du meilleur article rédigé par un étudiant doivent être transmis par la poste à la FCF, Concours du meilleur article rédigé par un étudiant, 595 Bay Street, bureau 1200, Toronto, ON M5G 2N5, ou par courriel à CTF_Awards@ctf.ca. Les dossiers doivent être accompagnés d’une lettre de recommandation du professeur ou du chargé d’enseignement du cours en fiscalité dans le cadre duquel l’article a été rédigé ainsi que des nom, adresse, numéro de téléphone et adresse courriel de l’étudiant. La date d’échéance de présentation des dossiers pour l’année universitaire 2013-2014 est le 30 juin 2014.
PRIX DE LA FONDATION CANADIENNE DE FISCALITÉ-FASKEN MARTINEAU DUMOULIN POUR L’ONTARIO

Jason T. Kujath (Récipiendaire 2012-2013)

La Fondation canadienne de fiscalité a le plaisir d’annoncer que monsieur Jason T. Kujath est le lauréat du Prix FCF-Fasken Martineau DuMoulin pour le meilleur article par un étudiant 2012-2013 de l’Ontario qui traite d’un aspect de la fiscalité canadienne.

L’article de M. Kujath intitulé « Canada v GlaxoSmithKline: Should We Modify the Arm’s Length Principle? » a été rédigé dans le cadre du programme Juris Doctor de l’Université de Windsor. M. Kujath a terminé avec succès le programme Juris Doctor de la faculté de droit de l’Université de Windsor. Il détient un baccalauréat en commerce, option finances. Jason complète présentement un stage auprès de Felesky Flynn LLP à Calgary, Alberta.

PRÉCIS

« Canada v GlaxoSmithKline: Should We Modify the Arm’s Length Principle? » commente et analyse le premier jugement de la CSC sur les prix de transfert. L’article porte sur comment gérer les prix de transfert tels qu’ils sont appliqués par l’Agence du revenu du Canada et par l’Agence des services frontaliers du Canada.

L’auteur discute des lignes directrices de la CSC sur l’évaluation appropriée et sur l’établissement des prix de transfert. Ce faisant, l’auteur est d’avis que la CSC n’a pas fourni une approche complète pour bien établir la valeur des biens remis. L’article stipule que les lignes directrices appropriées doivent spécifier l’éventail des circonstances qui seront prises en compte dans l’enquête hypothétique prévue au paragraphe 69(2). Au lieu, la CSC a vaguement conclu que la « réalité commerciale » devrait être considérée.

De plus, l’article contient une analyse critique du principe de « sans lien de dépendance » et il souligne les quatre énoncées suivants :

1. le principe de « sans lien de dépendance » en lien avec son application subjective;
2. une revue des circonstances subjectives qui doivent être considérées lorsque le principe de « sans lien de dépendance » est appliqué aux opérations commerciales des entités multinationales;
3. les intérêts concurrents de l’Agence du revenu du Canada et de l’Agence des services frontaliers du Canada; et
4. la compétitivité économique internationale de la juridiction.
**PRIX FCF-JEAN POTVIN POUR LE QUÉBEC**

**Antoine Desroches (Récipiendaire 2012-2013)**

La Fondation canadienne de fiscalité a le plaisir d’annoncer que monsieur Antoine Desroches est le lauréat du Prix FCF-Jean Potvin pour le meilleur article par un étudiant 2012-2013 du Québec qui traite d’un aspect de la fiscalité canadienne.


**PRÉCIS**

Le Canada est reconnu mondialement pour son généreux régime de recherche et développement (« R&D ») qui vise notamment à stimuler les retombées économiques et fiscales liées à la création de la propriété intellectuelle (« PI »). Toutefois, les objectifs sous-tendant la politique fiscale de ce régime ne sont que partiellement atteints. En effet, on assiste actuellement à un exode de la PI développée au Canada, en particulier à l’égard des brevets et des droits d’auteur liés aux logiciels informatiques, vers des territoires où les revenus en découvrant sont imposés à de plus faibles taux. Par conséquent, ce sont ces autres territoires qui jouissent des revenus liés à l’imposition de la PI conçue au Canada et souvent largement subventionnée par son régime de R&D. En d’autres mots, le Canada subventionne la main-d’œuvre spécialisée œuvrant dans le domaine de la R&D sans récolter les bénéfices économiques à long terme générés par cette main-d’œuvre.

Afin de contrer ce phénomène, certains pays ont adopté des régimes favorables à la détention de la PI, lesquels sont généralement désignés par le vocable *patent box*. Ceux-ci complètent habituellement un régime de R&D afin de stimuler l’innovation.

L’auteur analyse les structures fiscales utilisées par les entreprises multinationales afin d’exporter et d’exploiter la PI sans être assujetties à long terme à l’impôt canadien ainsi que les aspects techniques de certains *patent boxes* étrangers et la politique fiscale les sous-tendant. L’auteur considère également l’opportunité pour le Canada d’adopter un régime similaire qui, combiné à son programme de R&D, fournirait un incitatif considérable aux entreprises multinationales pour que non seulement elles développent, mais aussi détiennent, la PI au Canada.
PRIX FCF-BERT WOLFE NITIKMAN FOUNDATION POUR L’OUEST CANADIEN

Patrick Beatty (Récipiendaire 2012-2013)

La Fondation canadienne de fiscalité a le plaisir d’annoncer que monsieur Patrick Beatty est le lauréat du Prix FCF-Bert Wolfe Nitikman Foundation pour le meilleur article rédigé par un étudiant de l’Ouest canadien 2012-2013 qui traite d’un aspect de la fiscalité canadienne.

L’article de M. Beatty intitulé « When Politics and Economics Collide: Policy Implications for Reforming Oil and Gas Royalities » a été rédigé dans le cadre du projet de recherche du School of Public Policy de l’Université de Calagary. M. Beatty a obtenu une maîtrise en politique publique de l’Université de Calgary où il a reçu le prix Jack and Eleanor Mintz Graduate Scholarship en politique fiscale. M. Beatty est conseiller aux relations avec le gouvernement auprès de Suncor Energy à Calgary.

PRÉCIS

Les prix à la hausse du pétrole et du gaz naturel ont incité les gouvernements à obtenir leur part dans le développement du pétrole et du gaz. Depuis dix ans, l’Alaska et l’Alberta ont tous les deux mis à jour leur régime fiscal afin de s’assurer qu’ils reçoivent leur « juste part » des projets pétroliers. Les changements fiscaux instaurés dans les deux juridictions se sont avérés extrêmement controversés et ils ont provoqué un débat animé sur ce que devrait être la meilleure structure pour les royautés. En Amérique du Nord, le débat sur les régimes fiscaux comporte trop souvent un élément politique qui laisse pour compte les aspects économiques visant à obtenir un régime des plus efficaces. Cet article soutient que le débat politique sur le régime fiscal pétrolier et gazier ne reflète pas les aspects économiques d’une imposition efficace du pétrole et du gaz. Comme argument, l’article analyse les aspects économiques des royautés dans le domaine gazier et les politiques entourant les changements fiscaux en Alaska et en Alberta. L’expérience politique dans les deux juridictions est éclairante car elles offrent des similitudes et elles offrent d’excellentes études de cas sur comment s’effectuent les changements quant aux royautés. L’auteur conclut en donnant un aperçu sur comment les politiques et l’économie se sont entrechoquées ce qui a eu pour conséquences de produire des résultats moins qu’efficaces.
Estate planning offers taxpayers a means of distributing their assets, subsequent to death, in a way that minimizes tax liabilities for both the deceased and their beneficiaries. Serious obstacles can arise if the estate has non-resident beneficiaries and a significant portion of its value is derived from shares of a Canadian investment corporation. The authors of this two-part article examine Canadian and US tax implications for a Canadian resident who wishes to bequeath shares of a Canadian investment corporation to beneficiaries that include both Canadian and US residents. In part 1, the authors review how the residence of an estate is determined pursuant to Canadian rules and US tax rules, the application of US anti-deferral rules, and the resulting unexpected tax liabilities for US-resident beneficiaries. In part 2, they will discuss the use of unlimited liability corporations and other planning strategies that may be used to mitigate the overall tax burden on the deceased and their beneficiaries.

**KEYWORDS:** ESTATE PLANNING ● CONTROLLED FOREIGN CORPORATION ● NON-RESIDENT ● BENEFICIARIES ● DISTRIBUTIONS ● UNITED STATES
This article examines the statutory rules and case-law principles that determine the tax deduction that an individual may claim for an investment loss. It adds to what has previously been written on this topic by focusing on the situation of individuals who are victims of fraudulent investment schemes, using examples that have been considered by the Tax Court of Canada and the Federal Court of Appeal. It is hoped that this article will help investors and their advisers to make more prudent personal financial-planning decisions, as well as implement strategies that will enable them to provide better defences in the event of a claim for an investment loss of any kind.

**KEYWORDS:** TAX DEDUCTIONS ● LOSSES ● BUSINESS ● CAPITAL LOSSES ● FRAUD ● INVESTMENTS
Planification fiscale personnelle

Co-rédactrices : Pearl E. Schusheim* et Gena Katz**

Montants déductibles aux fins de l’impôt au titre des pertes de placement : leçons tirées de cas concernant des victimes de fraude en matière d’investissement

Joanne E. Magee***

Le présent article porte sur les règles législatives et les principes de jurisprudence qui déterminent la déduction fiscale qu’un particulier peut demander au titre d’une perte de placement. Il ajoute à ce qui a déjà été écrit sur le sujet en mettant l’accent sur la situation des victimes de fraude en matière de placement à l’aide d’exemples de causes entendues par la Cour canadienne de l’impôt et la Cour d’appel fédérale. Espérons qu’il aidera les investisseurs et leurs conseillers à prendre des décisions plus prudentes en matière de planification financière personnelle, et à mettre en œuvre des stratégies qui permettront une meilleure défense lors d’une demande de déduction au titre d’une perte de placement de quelque nature que ce soit.

Mots clés : Déductions fiscales ■ Pertes ■ Entreprise ■ Pertes en capital ■ Fraude ■ Placements

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*** De la School of Administrative Studies et School of Public Policy and Administration, York University, Toronto. J’aimerais remercier les rédactrices de chronique et Douglas Hartkorn pour leurs précieux commentaires sur les précédentes versions de cet article. Je suis naturellement seule responsable des erreurs qui auraient pu s’y glisser.
THE BUMP DENIAL RULES REVISITED

Brian R. Carr and Julie A. Colden

The Income Tax Act contains rules that permit a corporation to increase (“bump”) the tax cost of non-depreciable capital property of a subsidiary corporation when it winds up the subsidiary corporation or amalgamates with a wholly owned subsidiary. The Act also contains specific anti-avoidance provisions that deny the availability of the bump in certain circumstances. These bump denial rules have been subject to criticism based on their complexity, uncertainty as to their application, and various technical deficiencies in the drafting of the legislation. On October 18, 2013, the government introduced proposed legislative amendments that are intended to address some of these concerns.

This article reviews the current bump denial rules at a high level, focusing on several key definitions or concepts, and outlines some practical issues with respect to the application of the rules, including their application where property is acquired by a partnership. The article also reviews the proposed legislative amendments and considers whether, and to what extent, they resolve the issues that they were intended to address.

KEYWORDS: BUMP ■ WINDUPS ■ AMALGAMATIONS ■ ACQUISITIONS AND MERGERS ■ AMENDMENTS

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INTRODUCTION

The “bump” provided by paragraphs 88(1)(c) and (d) of the Income Tax Act¹ is one of the few means available under the Act to increase the tax cost of non-depreciable capital property of a corporation (referred to herein as a “target”) acquired through a share acquisition.² The tax cost of the shares of a target acquired in a taxable share acquisition reflects the current market value of such shares; in contrast, the tax cost of the underlying assets of the target reflects the historical cost of such assets. Usually, the fair market value of the shares will exceed the historical tax cost of the assets. (For the purposes of the discussion in this article, it is assumed that this is the case.)

On a windup or an amalgamation³ (referred to herein as a “merger”) of a subsidiary corporation into a parent corporation,⁴ the bump permits the higher “outside”

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¹ RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act. The term “bump” refers to the increase in basis of non-depreciable capital property when paragraphs 88(1)(c) and (d) apply.

² A corporation can also increase the tax cost of capital property on an acquisition of control by making a designation under paragraph 111(4)(e).

³ Subsection 88(1) applies in respect of a winding up. Subsection 87(11) applies to an amalgamation of a parent corporation and one or more wholly owned subsidiaries. Paragraph 87(11)(b) provides that “the cost to the new corporation of each capital property of the subsidiary acquired on the amalgamation is deemed to be the amount that would have been the cost to the parent of the property if the property had been distributed . . . to the parent on a winding-up of the subsidiary and subsections 88(1) and (1.7) had applied to the winding-up.”

⁴ Subsection 88(1) requires that both corporations must be taxable Canadian corporations. In addition, the parent must own at least 90 percent of the issued shares of each class of the capital stock of the subsidiary immediately before the winding up, and all of the shares of the subsidiary that were not owned by the parent immediately before the winding up must be owned by persons with whom the parent was dealing at arm’s length. (In the case of an amalgamation, the parent must own all of the shares of the subsidiary (other than directors’ qualifying shares) pursuant to the definition of “subsidiary wholly-owned corporation” in subsection 248(1). It is this definition that is applicable for the purpose of subsection 87(11), rather than the definition in subsection 87(1.4).) Herein, the term “parent,” “bump parent,” or “acquiror” refers to the parent, and the term “target” or “subsidiary” refers to the subsidiary, for the purposes of subsection 88(1).
basis of the shares of the subsidiary held by the parent to be pushed down to increase the tax cost to the parent of the underlying non-depreciable capital property of the target. Since the availability of the bump is limited to non-depreciable capital property of the subsidiary, the bump is most advantageous in circumstances in which non-depreciable capital property (such as shares of a subsidiary, land, or an interest in a partnership that owns shares of a subsidiary or land) is being disposed of to a third-party purchaser, or is being repositioned within a corporate group, following the acquisition.

For example, an acquirer may wish to divest specific assets after the acquisition of the target. The utilization of the bump to increase to fair market value the tax cost of the shares of a subsidiary holding the assets would facilitate the divestiture on a tax-efficient basis. Another typical example in which the bump is advantageous involves an acquirer resident in the United States (for example) acquiring, through a Canadian acquisition corporation, a Canadian target with an existing subsidiary resident in the United States. To eliminate the sandwich structure (US parent, Canadian target, US subsidiary), a bump in the tax cost of the shares of the US subsidiary on the merger of the Canadian acquisition corporation and the Canadian target would facilitate moving the US subsidiary “out from under” Canada on a tax-efficient

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5 The bump is available under paragraph 88(1)(c), which provides that the cost to the parent of capital property distributed on the winding up is the subsidiary’s cost amount of such property plus (unless the property is “ineligible property”) the amount determined under paragraph 88(1)(d). Paragraph 88(1)(d) provides that the amount by which the parent may increase the adjusted cost base of capital property acquired on the winding up (the “bump room”) is the amount by which the cost amount of the shares of the subsidiary (which should be the fair market value of such shares immediately following the acquisition of a target) exceeds the total of

1. the amount by which the total cost amount of all properties owned by the subsidiary immediately before the winding up, including the amount of money that the subsidiary has on hand, exceeds the total of
   a. the debts of the subsidiary outstanding immediately before the winding up, and
   b. certain reserves deducted in computing the subsidiary’s income for the taxation year, and
2. the total of all taxable dividends and capital dividends that the parent received on the shares of the subsidiary.

Subparagraph 88(1)(d)(ii) may reduce the bump room available in respect of shares of foreign affiliates (see infra note 8).


7 The relevant property must be owned by the subsidiary at the time of the acquisition of control (see the text of paragraph 88(1)(c) immediately following clause (ii)(B) and preceding subparagraph (iii)).
basis.8 Using the bump in this context to eliminate the sandwich structure avoids the negative consequences that may arise from the application of the foreign affiliate dumping rules.9

However, the bump denial rules preclude the possibility of obtaining a bump in some specifically defined circumstances. Generally, the bump denial rules were introduced into the Act to prevent so-called back-door butterflies.

A butterfly transaction permits a corporation to be split up, or its assets spun off, without the incidence of tax at the corporate level. A “purchase butterfly” facilitated the transfer of a portion of the assets of a corporation (“the transferor”) to another corporation (“the transferee”) in conjunction with the sale of the shares of either the transferor or the transferee without the incidence of corporate-level tax.10 A similar result could be obtained through a bump transaction pursuant to which a purchaser acquired a target corporation from its shareholder, bumped the tax cost of the target corporation’s underlying non-depreciable capital property to its fair market value, and then sold the bumped property back to the shareholder without incurring corporate-level tax.11

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8 Pursuant to subparagraph 88(1)(d)(ii), the bump room in respect of shares of a foreign affiliate is reduced pursuant to regulation 5905(5.4) by the amount of the foreign affiliate’s “tax-free surplus balance” as set out in regulation 5905(5.5). The shares of the foreign affiliate can still be distributed to the foreign acquiror without the realization of a capital gain in Canada if an election is filed pursuant to subsection 93(1).

9 The foreign affiliate dumping rules are contained in section 212.3.


11 For a more detailed discussion of purchase butterflies, back-door purchase butterflies, and the legislative purposes of the bump denial rules, see (in addition to the sources cited in note 10, supra) the following commentary: Manjit Singh, “An Introduction to the ‘Bump’ Rules,” in
The bump denial rules apply if certain former shareholders of the target corporation (commonly referred to as “prohibited persons”) that are defined by reference to the concept of “specified shareholder”\(^\text{12}\) acquire property distributed to the parent on the merger or property substituted therefor (commonly referred to as “prohibited property”), as part of the series of transactions or events that includes the merger.\(^\text{13}\) The concepts of prohibited property and prohibited persons are drafted so broadly and in such detail that it can be challenging to analyze the availability of the bump in the context of a particular transaction (or, more accurately, a series of transactions).

In the next section of the article, we examine those concepts as well as the application of the current bump denial rules in respect of acquisitions of property by a partnership. We will then consider the effect of proposed amendments to the current rules included in a notice of ways and means motion introduced on October 18, 2013.\(^\text{14}\)

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\(^{12}\) “Specified shareholder” is defined in subsection 248(1) and generally requires ownership of at least 10 percent of a class of shares. Pursuant to subsection 248(6), each series within a class is considered a separate class for the purposes of the Act.


\(^{14}\) Canada, Department of Finance, Notice of Ways and Means Motion To Implement Certain Provisions of the Budget Tabled in Parliament on March 21, 2013 and Other Measures, October 18, 2013 (herein referred to as “the legislative proposals”).
CONCEPTS AND DEFINITIONS
As noted above, the paragraph 88(1)(d) bump will be denied if distributed property or substituted property is acquired by a prohibited person as part of the series. The concepts of distributed property and substituted property, and the related concept of specified property, are described in turn below. A discussion of specified shareholders and specified persons follows. The application of the bump denial rules to partnerships is also discussed.

Distributed Property
There is no definition of distributed property in subsection 88(1). The phrase refers to any property distributed to the parent on the merger. The bump will not be available in respect of a particular distributed property if any distributed property or substituted property is acquired by a prohibited person. It is not necessary for the tax cost of a property acquired by a prohibited person to have been bumped under paragraphs 88(1)(c) and (d) (or even that such property constitute non-depreciable capital property) to preclude the bump in respect of all property distributed by the target corporation on the merger. For example, money could be distributed by a subsidiary to the parent on the merger and therefore could constitute distributed property.15 If such money was acquired by a specified shareholder, the bump would be denied in respect of all non-depreciable capital property of the subsidiary. This circumstance could arise, for example, if funds of the subsidiary were used for payments to former shareholders of the target corporation or if there was an ongoing relationship between the merged entity and the target’s former shareholders, such as a leasing arrangement.

Substituted Property
The definition of substituted property16 is inclusive rather than exhaustive. The “ordinary” meaning of property acquired in substitution for other property and the rule in subsection 248(5) that provides for tracing through multiple substitutions17 are also relevant.

Much of the substantive analysis in determining the availability of the bump engages the definition of substituted property. Subject to certain exceptions, substituted

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15 While money cannot constitute substituted property pursuant to subparagraph 88(1)(c.3)(iii), there is no such exception for distributed property.
16 Defined in paragraph 88(1)(c.3) for the purpose of clause 88(1)(c)(vi)(B).
17 Specifically, subsection 248(5) provides that where property has been disposed of or exchanged in substitution for another property through more than one substitution, the property acquired in any such substitution is deemed to have been substituted for the initial property. (Subsection 248(5) also provides that a share received as a stock dividend is deemed to be property substituted for that share.)
property includes attributable property and determinable property\(^{18}\) owned at any time after the acquisition of control of the target.\(^{19}\) Attributable property is property the fair market value of which is, at that time, wholly or partly attributable to distributed property\(^{20}\) (other than “specified property”). Determinable property is property the fair market value of which is determinable by reference to the fair market value of the distributed property.\(^{21}\)

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18 These terms refer to substituted property described, respectively, in subparagraphs 88(1)(c.3)(i) and (ii). The terms are not used in the legislation itself.

19 Paragraph 88(1)(c.3) lists a number of exclusions from the concept of substituted property, specifically

- money (subparagraph 88(1)(c.3)(iii));
- property that was not owned by a prohibited person at any time after the acquisition of control (subparagraph 88(1)(c.3)(iv));
- property that is attributable property only because a certain specified property was received as consideration for the acquisition of the shares of the target in certain circumstances (subparagraph 88(1)(c.3)(v));
- a share of the target or debt owed by the target that was owned by the parent immediately before the winding up (subparagraph 88(1)(c.3)(vi)); and
- a share of a corporation or debt owed by a corporation, if the fair market value of the share or debt was not, at any time after the beginning of the winding up, wholly or partly attributable to distributed property (subparagraph 88(1)(c.3)(vii)).

These exclusions are relevant to the statutory concepts of attributable property and determinable property, as well as the ordinary meaning of substituted property (taking into account subsection 248(5)). In large part, they were introduced to address specific fact patterns; for example, subparagraphs 88(1)(c.3)(vi) and (vii) were introduced to address technical issues involving safe-income strips. For a discussion, see John A. Chan, “December 20, 2002 Technical Bill—Selected Domestic Topics,” in 2003 Prairie Provinces Tax Conference (Toronto: Canadian Tax Foundation, 2003), 2:1-22.

20 Subparagraph 88(1)(c.3)(i).

21 Subparagraph 88(1)(c.3)(ii). An important distinction between attributable property and determinable property is that “specified property” is excluded from attributable property, but not from determinable property. This leaves open the possibility that shares of an acquiror that are not attributable property (because they constitute specified property) may constitute determinable property if the fair market value of the shares of an acquisition corporation could be said to be determinable by reference to the fair market value of distributed properties. On a broad construction, the shares of any acquisition corporation could technically be considered determinable property. The Department of Finance technical notes accompanying subparagraph 88(1)(c.3)(ii) and administrative statements by the Canada Revenue Agency (CRA) suggest that generally the definition of determinable property should be limited to tracking property or other property the value of which is dependent on the value of distributed property. (See, respectively, Canada, Department of Finance, Explanatory Notes Relating to Income Tax (Ottawa: Department of Finance, December 1997), at subclause 118(6); and Canada Revenue Agency, Income Tax Technical News no. 9, February 10, 1997 (now cancelled).)

However, the statements also suggest that if a series of steps succeeds in breaking up a corporation without the incidence of corporate-level tax and the vending shareholder ends up holding the majority of shares of a corporation substantially all of the value of which is attributable to distributed property (absent the extracted assets), then these rules will apply.
Any upstream equity interests (such as shares of the parent or other upper-tier corporate or partnership interests) or debt of any upstream entities owned after the acquisition of control will constitute substituted property since the value of such property will be considered wholly or partly attributable to distributed property.22

**Specified Property**

As noted above, substituted property does not include “specified property.”23 The categories of property included in the definition of specified property reflect to some extent specific policy considerations, at least as far as shares or debt of parent or grandparent corporations is concerned.24 While shares or debt of a Canadian corporation can be specified property if received as consideration for the acquisition

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22 Subparagraph 88(1)(c.3)(i). The exceptions referred to in note 19, supra, are not discussed in detail here because they are typically not relevant to the characterization of upstream equity or debt interests as substituted property.

23 Defined in paragraph 88(1)(c.4).

24 For a discussion of the policy concern that the legislation may be attempting to address, see, for example, Angelo Nikolakakis and Alain Léonard, “The Acquisition of Canadian Corporations by Non-Residents: Canadian Income Tax Considerations Affecting Acquisition Strategies and Structure, Financing Issues, and Repatriation of Profits,” in Report of Proceedings of the Fifty-Seventh Tax Conference, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 21:1-61, at 21:24-25:

> [I]t is clear that this distinction in treatment [between resident and non-resident corporations] is not based on any principled conception of continuing economic proximity between the Target stakeholders and the distributed property (the assets of Target). Indeed, if that were the basis for drawing a principled distinction in this context, we suggest that there is likely to be greater proximity when the transaction consideration consists of shares of a taxable Canadian corporation than when it consists of shares of a non-resident Bidder, on the basis that a non-resident Bidder may be more likely to have assets other than the distributed property, and therefore that a smaller part of the [fair market value] of the shares of a non-resident Bidder may be attributable to the distributed property. What is not at all clear, then, is the basis for this distinction in treatment.

> Why is it that shares of a non-resident Bidder should not constitute “specified property”? The answer to this question too seems to have nothing to do with the treatment of the proceeds of disposition to the Target stakeholders. . . .

> What is the problem, then, under paragraph 88(1)(c)? The Department of Finance may be considering whether or not it should be concerned about transactions by which non-Canadian assets are removed from Canadian corporate solution against tax attributes generated by consideration paid in foreign equity instead of cash or Canadian equity. At least with share consideration issued by a Canadian Bidder, the assets remain in Canadian corporate solution. In contrast, where non-Canadian assets are bumped and then distributed to a non-resident Bidder, there is no further Canadian tax claim with respect to these assets.
of the shares of the target,\textsuperscript{25} under the current law, shares or debt of a foreign corporation cannot constitute specified property.\textsuperscript{26}

The effect of these rules is that, under the current law, while it is possible for a Canadian acquirer to use its shares or debt (which would otherwise constitute attributable property) as consideration for the acquisition of a target without compromising the availability of the bump, the bump is not available if a non-Canadian acquirer uses its shares or debt as consideration for the acquisition of the shares of the Canadian target. This is clearly a tax policy decision; one commentator has indicated that the policy consideration underlying these provisions is a concern regarding erosion of the Canadian tax base.\textsuperscript{27} The same commentator has suggested the following as an example of a transaction that the Department of Finance sought to prevent.\textsuperscript{28}

\begin{quote}
\textit{Example}

Non-resident shareholders own a Canadian corporate target. The assets of the target consist primarily of shares of foreign corporations. A non-resident acquirer establishes and capitalizes a Canadian acquisition corporation (creating cross-border paid-up capital \textit{[PUC]} to acquire the target. The \textit{PUC} of the Canadian acquisition corporation is equal to the amount used to capitalize the corporation. The Canadian acquisition corporation subscribes for shares of the non-resident acquirer and uses those shares as consideration for the acquisition of the target. Following the acquisition, the target is wound up into the Canadian acquisition corporation, and the tax cost of the shares of the respective foreign corporations is bumped. The shares of the foreign corporations are then distributed by the merged Canadian acquisition corporation to the non-resident acquirer as a return of capital.
\end{quote}

\textsuperscript{25} Specifically, under the current law, shares of a parent corporation (which must always be a taxable Canadian corporation) received as consideration for the acquisition of shares of the target by the grandparent or parent constitute specified property (clause 88(1)(c.4)(i)(A)), as do shares of a grandparent that is a taxable Canadian corporation received as consideration for the acquisition of shares of the target by the grandparent or parent (subparagraph 88(1)(c.4)(iii)). Similarly, indebtedness issued by the parent corporation as consideration for the acquisition of the shares of the target by the parent is specified property (subparagraph 88(1)(c.4)(ii)), as is indebtedness of a grandparent that is a taxable Canadian corporation received as consideration for the acquisition of shares of the target by the parent or grandparent (subparagraph 88(1)(c.4)(iv)). Specified property also includes shares of the parent issued for consideration that consists solely of money (clause 88(1)(c.4)(i)(B)), and certain other properties described in subparagraphs 88(1)(c.4)(v) and (vi).

\textsuperscript{26} As discussed below, the legislative proposals, if enacted, will remove this restriction in limited circumstances.

\textsuperscript{27} Ton-That, supra note 11, at 27.27-28.

\textsuperscript{28} Ibid., at 27.28.
Since the enactment of the bump denial rules, there have been many changes to the income tax regime, including in particular the introduction of comprehensive foreign affiliate dumping rules directed in part at base erosion.\(^{29}\) Those rules may reduce the cross-border PUC of shares of a Canadian acquisition corporation established by a non-resident if more than 75 percent of the value of the shares of the target is derived from shares of foreign affiliates.\(^{30}\) However, the rules permit the shares of the foreign affiliates to be distributed to the non-resident as a return of capital through the operation of the PUC reinstatement rules operative immediately before the distribution.\(^{31}\) It is well understood that this result was a deliberate policy decision by the Department of Finance, since an earlier version of the rules did not contain such a PUC reinstatement rule. Thus, given the enactment of a comprehensive set of rules directed at base erosion through investments in foreign affiliates, including indirect investments through a Canadian corporation the value of which is derived from shares of foreign affiliates, it is not clear that the policy considerations underlying the limitation on the availability of the bump where shares of a non-resident corporation are used as consideration in the acquisition of a Canadian target remain compelling.

**Specified Shareholder**

The concept of prohibited persons incorporates a modified version of the definition of “specified shareholder” in subsection 248(1). Under the bump denial rules, a specified shareholder (and aggregations of persons defined by reference to specified shareholder status), other than a specified person,\(^{32}\) cannot acquire distributed property or substituted property as part of the series.\(^{33}\) For this purpose, a specified shareholder of a corporation in a taxation year is a taxpayer that owns at any time in the taxation year at least 10 percent of the issued shares of any class of shares\(^{34}\) of a corporation or of any related corporation, and that has a significant direct or indirect interest in any issued shares of the corporation.\(^{35}\) For the purposes of the definition, a lookthrough rule is applicable to partnerships pursuant to which each member of a partnership is deemed to own a proportion of the shares of a corporation that

\(^{29}\) See generally section 212.3.  
\(^{30}\) Paragraph 212.3(10)(f).  
\(^{31}\) Subsection 212.3(9).  
\(^{32}\) For the purposes of this discussion, unless otherwise indicated, it should be assumed that the relevant persons are not specified persons (discussed in a separate section below).  
\(^{33}\) It should be assumed for the purposes of this discussion that the relevant property is not specified property pursuant to paragraph 88(1)(c.4).  
\(^{34}\) Certain types of preferred shares are excluded. More particularly, pursuant to subparagraph 88(1)(c.2)(iii), shares of a “specified class” (defined in paragraph 88(1)(c.8)) are not considered in determining whether a person (or aggregation of persons) satisfies the definition of a specified shareholder.  
\(^{35}\) Subparagraph 88(1)(c.2)(iii).
are partnership property based on the fair market value of the member’s partnership interest relative to the fair market value of all interests in the partnership.36

**Aggregation Rules**

There are different ways in which shareholdings are aggregated for the purposes of the bump denial rules. First, in determining whether a taxpayer is a specified shareholder, the taxpayer is deemed to own each share of the capital stock of a corporation that is owned at the particular time by a person with whom the taxpayer does not deal at arm’s length.37 As a result, all shareholdings within a non-arm’s-length group will be aggregated for the purpose of determining whether any taxpayer in the group is a specified shareholder. The bump will be denied if any member (even a member that owns no shares of the target) of a non-arm’s-length group that owns in aggregate 10 percent or more of the issued shares of any class of shares of the target acquires distributed property or substituted property.

**Aggregation Rule in Subclause 88(1)(c)(vi)(B)(II)**

In addition, the bump will be denied if distributed property or substituted property is acquired as part of the series by two or more persons (other than specified persons) who, if treated as one notional person, would constitute a specified shareholder of the target at any time during the series and before the parent last acquired control of the target.38 This means that in analyzing whether the bump is available, in addition to specified shareholders, other persons acquiring prohibited property and their share ownership of the target (if any) should be considered. For example, employees could receive shares of a parent, or be issued employee stock options, as a bonus in the context of an acquisition such that the shares or options would not constitute specified property. If such employees owned in aggregate 10 percent or more of a class of shares of the target prior to its acquisition, the bump would be denied. No connection or relationship between the persons acquiring prohibited property for the purpose of this aggregation rule is necessary.

Moreover, any category of distributed or substituted property acquired as part of the series must be taken into account and aggregated. For example, if the employees referred to above (employees receiving stock options) held in total 6 percent of the shares of the target, and other shareholders of the target that in total held 4 percent of the shares of the target prior to its acquisition also subscribed for shares of an upstream foreign corporation as part of the series, the bump would be denied. In those circumstances, two or more persons who, if treated as one notional person,

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36 Paragraph (c) of the definition of “specified shareholder” in subsection 248(1). Similar rules are applicable in respect of trusts and their beneficiaries. The interaction of this lookthrough rule and the deeming provision in subparagraph 88(1)(c.2)(ii) is discussed below under “Partnerships.”

37 Paragraph (a) of the definition of “specified shareholder” in subsection 248(1).

38 Subclause 88(1)(c)(vi)(B)(II).
would be a specified shareholder, would have acquired substituted property. There is also no specific quantification relevant in respect of the distributed property or substituted property acquired by an aggregation of persons. The aggregation of persons need not acquire shares or options in respect of the acquiror that total at least 10 percent of the value of the target (for example). The relevant measure is the percentage of the shares of the target held prior to the acquisition of control by persons acquiring prohibited property as part of the series.

This aggregation rule can be relevant where the ultimate acquiror is a partnership such as a private equity fund. If the partnership raised equity financing for the acquisition by requiring its partners to subscribe for additional partnership units, the bump would be denied if the partners in aggregate held 10 percent or more of the shares of the target before the acquisition of control and as part of the series. Since the partnership units would be substituted property, an aggregation of persons (that, if treated as one notional person, would be a specified shareholder) would acquire substituted property as part of the series. For this reason, a fund will sometimes seek representations from its partners regarding their share ownership of a target if the availability of the bump is an important structuring consideration in the acquisition.

While a discussion of “series” is beyond the scope of this article, the concept for the purposes of the Act is very broad and includes any transaction undertaken in contemplation of the series, in the sense that the person took the series into account when undertaking the transaction. A person subscribing for shares or debt as part of the acquisition financing may well do so as part of the series. In addition, a person purchasing shares or debt in a public market transaction may take into account a proposed acquisition of a target in making its investment decision and thus could be considered to acquire such property as part of the series.

In a recently released technical interpretation, the Canada Revenue Agency (CRA) has provided some comfort on the issue of whether substituted property acquired by persons described in subclause 88(1)(c)(vi)(B)(II) would occur as part of the series. Specifically, in the document, the CRA provided an opinion (but not a ruling) that the acquisition of shares or debt of a parent (and other relevant entities) by persons that would not be described in clause 88(1)(c)(vi)(B) if subclause (II) was ignored (for example, if the persons were not specified shareholders) would “not necessarily” occur as part of the relevant series. This statement is helpful in that there should typically be a residual position that any acquisition of property by persons that had no involvement in the formulation of the series should not be

39 As described in subclause 88(1)(c)(vi)(B)(II).
40 See the extended meaning of “series of transactions” in subsection 248(10) and the related case law and commentary cited in note 13, supra.
41 As discussed infra note 59, indebtedness issued solely for cash consideration should constitute specified property under the legislative proposals.
43 Ibid.
considered to occur as part of the relevant series. While this opinion represents express acknowledgment by the CRA of this position, “not necessarily” is hardly a definitive affirmation of the CRA’s administrative practice.

For the purpose of the application of the aggregation rule in subclause 88(1)(c)(vi)(B)(II), shares held within a non-arm’s-length group are not aggregated. That is, in determining whether a person is a specified shareholder, shareholdings of all non-arm’s-length persons are aggregated. If the 10 percent threshold is met, then all non-arm’s-length group members are specified shareholders of the target. If the 10 percent threshold is not met within the non-arm’s-length group, in applying the aggregation test in subclause 88(1)(c)(vi)(B)(II), only the shareholdings of the persons actually acquiring distributed or substituted property are aggregated (not the shareholdings of non-arm’s-length persons). Consider the following example. One member of a non-arm’s-length group (“member A”) holds 2 percent of the shares of a target, while another member of the group (“member B”) holds 5 percent of the shares of the target. If member A acquires prohibited property (for example, units of an upstream partnership), the shares of the target held by member A must be aggregated with the shareholdings of all other entities acquiring prohibited property as part of the series in determining whether the threshold in subclause 88(1)(c)(vi)(B)(II) is satisfied. The 5 percent shareholding of member B is not taken into account (assuming that member B does not also acquire prohibited property as part of the series). While the definition of specified shareholder provides that a taxpayer is deemed to own each share owned by a non-arm’s-length person, this rule is applicable only for the purpose of that definition. Of course, if member A owned 6 percent of any class of shares of the target and member B owned 5 percent of any class of the target’s shares, then all group members would be specified shareholders, and any acquisition of distributed property or substituted property by any group member would preclude the use of the bump.

Another CRA technical interpretation states that the phrase “all of the shares” in subclause 88(1)(c)(vi)(B)(II) (and presumably in subclause (III), discussed below) does not refer only to shares of the target. In the CRA’s view, the phrase refers to the shares of any corporation. Thus, if an aggregation of persons that acquired prohibited property as part of the series owned 10 percent or more of the shares of a corporation that was related to the target (and that had a significant direct or indirect interest in the target), the bump would be denied. While this interpretation might expand the application of the bump denial rules, as a practical matter it likely would not be relevant to most public company transactions.

**Aggregation Rule in Subclause 88(1)(c)(vi)(B)(III)**

Subclause 88(1)(c)(vi)(B)(III) describes further categories of prohibited persons by reference to specified shareholder status and the aggregation rule described above.45

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45 Specified persons and the target are not prohibited persons under subclause 88(1)(c)(vi)(B)(III).
First, a corporation (other than a specified person) that has a specified shareholder in common with a target is a prohibited person. That is, if a shareholder owns 10 percent of a class of the shares of the target and also owns 10 percent of the shares of an unrelated corporation that is not a specified person, the unrelated corporation cannot acquire distributed or substituted property as part of the series. In the public company context, as a practical matter, if there is a known specified shareholder, it may be prudent to confirm that that specified shareholder does not also own 10 percent or more of the shares of an acquiror (either alone or together with non-arm’s-length persons).

Further, where two or more persons (other than specified persons) would, if treated as one notional person, be a specified shareholder of a corporation after the acquisition of control, and such notional person would also be a specified shareholder of the target, such corporation will be a prohibited person. Consider the situation, for example, where (1) shareholder A owns 5 percent of a class of shares of the target and also owns 2 percent of the shares of a particular corporation, and (2) shareholder B owns 5 percent of the same class of shares of the target and also owns 8 percent of the same class of shares of the corporation. If shareholders A and B were treated as one notional person, the notional person would be a specified shareholder of the target and of the corporation. As a practical matter, in the context of public company transactions, it will be virtually impossible in many situations to monitor compliance with this rule.

**Specified Person**

A specified person is an otherwise prohibited person that can acquire prohibited property as part of the series without causing the application of the bump denial rules. Consequently, status as a specified person is desirable.

A specified person, at any time, means the parent and each person that would, without regard to paragraph 251(5)(b) rights, be related to the parent. Obviously, to claim the bump, the parent must acquire distributed property as part of the series. The inclusion of related persons in the definition permits intragroup transfers of

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46 Sub-subclause 88(1)(c)(vi)(B)(III)(1). The relevant person must be a specified shareholder of the target before the acquisition of control and a specified shareholder of the other corporation after the acquisition of control.

47 Sub-subclause 88(1)(c)(vi)(B)(III)(2). The notional person would have to be a specified shareholder of the target before the acquisition of control and a specified shareholder of the particular corporation after the acquisition of control. As well, the relevant shareholders must have acquired the shares of the particular corporation as part of the series.

48 Subparagraph 88(1)(c.2)(i). However, a person is deemed not to be related to the parent “where it can reasonably be considered that one of the main purposes of one or more transactions or events was to cause the person to be related to the parent so as to prevent a property that was distributed to the parent on the winding-up from being an ineligible property for the purpose of [the bump].” The legislative proposals would move this anti-avoidance provision (currently in subparagraph 88(1)(c.2)(i)) to new subparagraph 88(1)(c.2)(i.1).
distributed property without regard to whether a related entity was a specified shareholder or otherwise a prohibited person prior to the acquisition of control of the target.

**PARTNERSHIPS**

There is some uncertainty in the application of the bump denial rules in respect of the acquisition of property by a partnership. The bump denial rules in subparagraph 88(1)(c)(vi) refer to acquisitions of property by any “person.” Generally, a partnership is not a person for the purposes of the Act (although in some instances a partnership may be deemed to be a person). Uncertainty results because of the interaction of the definition of “specified shareholder” in subsection 248(1) and the deeming rule in subparagraph 88(1)(c.2)(ii), which is applicable for the purposes of paragraph 88(1)(c.2) and subparagraph 88(1)(c)(vi).

Under the lookthrough rules in the definition of “specified shareholder,” a partnership cannot itself be a specified shareholder; rather, as discussed above, each member of a partnership is deemed to own a proportion of the shares of a corporation that are partnership property based on the fair market value of the member’s partnership interest relative to the fair market value of all interests in the partnership. Therefore, specified shareholder status is determined at the partner level on a lookthrough basis.

However, subparagraph 88(1)(c.2)(ii) provides that where at any time a property is owned or acquired by a partnership

- the partnership is deemed to be a corporation;
- that corporation is deemed to have one class of issued shares;
- each member of the partnership is deemed to own at that time a proportion of the number of issued shares of the capital stock of the corporation based on the pro rata fair market value of the member’s partnership interest; and
- the property is deemed to have been owned or acquired by the corporation at that time.

This approach (deeming a partnership to be a corporation and referring only to an acquisition of property by a person) contrasts with the continuity-of-interest rules in the butterfly context, which do not deem a partnership to be a corporation and

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49 See subsection 66(16), which deems a partnership to be a person for the purposes of the flowthrough share rules. However, relying on the provisions of subsection 96(1), the CRA considers a partnership to be a person for the purposes of income computation at the partnership level: see, for example, “Revenue Canada Round Table,” in Report of Proceedings of the Forty-Second Tax Conference, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 50:1-68, question 28, at 50:16.

50 See supra note 36 and the related text.

51 Similar rules also apply in respect of trusts and their beneficiaries (see subparagraph 88(1)(c.2)(ii)).
instead refer to an acquisition of property by a “person or partnership.”52 An earlier iteration of the bump denial rules contained similar language.53

As a result of the interaction of subparagraph 88(1)(c.2)(ii) and the definition of “specified shareholder,” it is not clear whether or when the bump denial rules may apply in respect of an acquisition by a partnership. If a partnership owns 10 percent or more of a class of shares of a target corporation, the partnership will be a specified shareholder pursuant to the application of subparagraph 88(1)(c.2)(ii) for the purposes of subparagraph 88(1)(c)(vi), and the partnership cannot acquire distributed property or substituted property as part of the series. However, a partner in a partnership can still be a specified shareholder pursuant to the definition in subsection 248(1) since subparagraph 88(1)(c.2)(ii) does not override the lookthrough rule.

The aggregation rules in subclause 88(1)(c)(vi)(B)(III) must also be considered having regard to the application of the deeming rule in subparagraph 88(1)(c.2)(ii) in respect of an acquisition of property by a partnership. For example, if a specified shareholder of a target was a member of a partnership and that member’s partnership interest constituted at least 10 percent of the fair market value of all interests in the partnership, the acquisition of distributed property or substituted property by the partnership as part of the series would preclude the bump on the combined basis of sub-subclause 88(1)(c)(vi)(B)(III)(1) and the deeming rule in subparagraph 88(1)(c.2)(ii). That is, a (deemed) corporation of which a specified shareholder of the target was also a specified shareholder would have acquired prohibited property. Further, if two or more shareholders of the target (other than specified persons) whose shareholdings in the target were at least 10 percent in aggregate were members of a partnership and the fair market value of their aggregate partnership interests was at least 10 percent of the fair market value of all partnership interests, the bump would be precluded as a result of the combined operation of sub-subclause 88(1)(c)(vi)(B)(III)(2) and subparagraph 88(1)(c.2)(ii). That is, a deemed corporation of which two or more persons (other than specified persons), if treated as one notional person, would constitute a specified shareholder, and would also constitute a specified shareholder of the target, would have acquired prohibited property. As a result of these rules (as well as the rule discussed below), it may be prudent for a private equity fund to make inquiries of its members regarding their share ownership in a target (assuming that substituted property is acquired as part of the series) if the bump is an important structuring consideration.

52 See, for example, paragraph 55(3.1)(b). Also see the discussion in note 10, supra, and the sources cited therein.

The acquisition of partnership interests by members of the partnership (that are not themselves partnerships) may still preclude the bump on the basis that the partnership interests are substituted property. The deeming rule in subparagraph 88(1)(c.2)(ii) applies for the purposes of paragraph 88(1)(c.2) and subparagraph 88(1)(c)(vi) in respect of property owned or acquired by a partnership but not in respect of the acquisition of partnership interests (unless the acquiror is itself a partnership).

Notwithstanding the lookthrough rule applicable for the purpose of determining specified shareholder status, a partnership can be a specified person. The preamble of paragraph 88(1)(c.2) expressly applies for the purposes of that paragraph as well as subparagraph 88(1)(c)(vi). Thus, the rule in subparagraph 88(1)(c.2)(ii) that deems a partnership to be a corporation is applicable to the definition of “specified person” (subparagraph 88(1)(c.2)(i)). For example, a partnership (such as a private equity fund) that establishes an acquisition corporation should be a specified person because, as a deemed corporation, the fund should be related to the acquisition corporation. However, if multiple funds are involved in forming the acquisition corporation, it may not be the case that all of those funds will be specified persons. Further, if each fund owns 50 percent or less of the shares of the target, none of the funds may be a specified person. This could be problematic, for example, in circumstances where a fund establishes a toehold position in a target of at least 10 percent, causing it to constitute a specified shareholder prior to the acquisition of control of the target.

If the fund does not control the acquisition corporation, it likely will not constitute a specified person. Consequently, any acquisition of attributable property (other than specified property) by the fund would preclude the bump.

LEGISLATIVE PROPOSALS

The legislative proposals are relieving in nature and in large part propose amendments based on a number of comfort letters issued by the Department of Finance since 2002. In some cases, the proposals address the issue fairly narrowly, and technical problems remain. The proposals also do not address the uncertainty, discussed above, with respect to the application of the bump denial rules to partnerships.

In this section, we discuss the legislative proposals relevant to the concepts of substituted property and specified property (prohibited property), and the proposals affecting specified persons and specified shareholders (prohibited persons).

SUBSTITUTED PROPERTY AND SPECIFIED PROPERTY

The following are the legislative proposals relevant to the concepts of substituted property and specified property:

- the introduction of a “safe harbour” into the definition of substituted property;\(^{54}\)

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\(^{54}\) Proposed subparagraph 88(1)(c.3)(i).
expansion of the definition of specified property to include indebtedness in certain circumstances;\textsuperscript{55}  
the status of stock options as substituted property;\textsuperscript{56}  
the introduction of a rule that provides that distributed property is deemed not to have been acquired by a person if it was acquired prior to the acquisition of control and is not owned at any time after the acquisition of control;\textsuperscript{57}  
clarification in respect of amalgamation squeeze-out transactions.\textsuperscript{58}

Below, we review these proposals and consider whether they appropriately deal with the current problems with the bump rules that they aimed to address.

**Safe Harbour**

The concept of substituted property (and, in particular, attributable property) is extremely broad. Subject to exceptions for specified property, substituted property includes virtually any upstream debt or equity interest in the target. The legislative proposals narrow the concept of attributable property by introducing a safe harbour concept into subparagraph 88(1)(c.3)(i).\textsuperscript{59} Under the legislative proposals, property owned at any time after the acquisition of control will be substituted property only if more than 10 percent of its fair market value is, at that time, attributable to distributed property. The Department of Finance indicates in the technical notes accompanying the legislative proposals that the 10 percent threshold has been introduced “to limit the type of property that is deemed to be substituted property”

\textsuperscript{55} Proposed clause 88(1)(c.4)(ii)(B).  
\textsuperscript{56} Proposed paragraph 88(1)(c.9).  
\textsuperscript{57} Proposed subparagraph 88(1)(c.2)(ii).  
\textsuperscript{58} Proposed subparagraph 88(1)(c.4)(v).  
\textsuperscript{59} Consequent upon this amendment was the removal from the draft legislation of a prior proposal also of potentially broad scope. Former proposed subparagraph 88(1)(c.4)(vi) provided that if the shares of the subsidiary were acquired by the parent for consideration that consisted solely of money, a share of any corporation would be specified property (proposed in the December 2002 legislative proposals, clause 36). Under the current law, a share of the parent issued solely for cash consideration is specified property. The prior proposal would also have permitted shares of a non-resident acquiror to constitute specified property, provided that the shares of the target were acquired for cash. For example, under that proposal, a non-resident acquiror could have raised capital through an equity issuance and then used the proceeds to fund the acquisition by a Canadian corporation of the shares of the target for cash consideration. The shares of the non-resident would have been specified property under the prior proposal since the shares of the target would have been acquired by the parent for consideration that consisted solely of money. Since the amendment in the current legislative proposals is a previously announced measure, it will have application from 2001 to December 21, 2013 (with transitional relief for mergers that were evidenced in writing prior to December 21, 2013 and undertaken before July 2013).
and thus “simplify the application of the bump denial rule.” The Department of Finance further indicates that the introduction of this threshold should reduce the need to create an exhaustive list of acceptable properties through the definition of specified property.

While the legislative proposal is fairly narrow, as a relieving measure it will be welcomed by taxpayers. Since property will not be substituted property unless 10 percent or more of its fair market value is attributable to distributed property, the legislative proposals open up, in limited circumstances, the possibility of the bump being available when shares of a non-Canadian corporation are issued to shareholders in consideration for the acquisition of a Canadian target. Under the current law, such shares constitute substituted property since their value is attributable to distributed property, and the shares cannot be specified property. Under the legislative proposals, if the value of the distributed properties was less than 10 percent of the value of the non-resident corporation, shares of that corporation should not be substituted property. This could be the case if a foreign multinational acquired a Canadian target. Provided that the Canadian target represented less than 10 percent of the value of the non-resident corporation, the bump would not be precluded simply because shares of the non-resident corporation were issued to shareholders of the target.

A criticism of this legislative proposal is that all values necessarily fluctuate over time. Under subparagraph 88(1)(c)(vi), property is ineligible for the bump if substituted property is acquired by prohibited persons as part of the series. Property will not qualify for the safe harbour if a prohibited person acquires the property as part of the series and at any time after the acquisition of control, more than 10 percent of the value of the property is attributable to distributed property. Thus, if the value of the distributed properties appreciated over time relative to the value of the other assets, the relevant property could become substituted property. Technically, the value shift may not have to occur as part of the series; only the acquisition of substituted property must be part of the series (and property will be substituted property if at any time after the acquisition of control more than 10 percent of its value is attributable to substituted property). The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (“the joint committee”) has commented on this issue, but no adjustment was made to the text of the legislative proposals from the original draft legislation (released in December 2012) relative to the October 2013 notice of ways and means motion.

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61 Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, “Re: December 21, 2012 Technical Amendments,” submission to the Department of Finance, February 13, 2012. (All references herein to comments of the joint committee are to this submission.)

However, as a practical matter, the provision may be construed as a point-in-time test or a throughout-the-series test.

**Indebtedness**

The legislative proposals expand the circumstances in which indebtedness may constitute specified property. Since the value of indebtedness of a parent (or other upstream entity) will be considered to be attributable to distributed properties, such indebtedness under the current law constitutes substituted property. However, under the current law, specified property includes indebtedness issued by the parent as consideration for the acquisition of the shares of the subsidiary by the parent. This category of specified property obviously permits notes to be issued by an acquiror as consideration for the shares of a target without compromising the availability of the bump.

This category of specified property is also relevant in the structuring of dissent rights under a plan of arrangement, which is a fairly common acquisition structure for takeovers of Canadian corporations. Generally, under a plan of arrangement, minority shareholders have a statutory right of dissent. If the plan of arrangement ultimately receives shareholder approval, dissenting shareholders will be entitled to receive fair value for their shares at a later date. The dissent right represents indebtedness the value of which would be attributable to distributed property. If the plan of arrangement provides that the shares held by dissenting shareholders are to be acquired by the acquiror in exchange for payment, such indebtedness will constitute specified property since it will be issued by the parent as consideration for the acquisition of the shares of the subsidiary. In contrast, if the plan of arrangement provides that the shares held by dissenting shareholders are to be cancelled for payment, while such indebtedness will constitute substituted property, it will not be specified property. Thus, in the latter example, the acquisition of such substituted property (being the right of dissenting shareholders to receive fair value for their shares) will have to be taken into account in determining whether prohibited persons have acquired property. Consequently, it is usually preferable, from a bump perspective, to structure dissent rights in a plan of arrangement such that the shares of dissenting shareholders are to be acquired by the acquiror in return for payment.

The current law does not address circumstances in which an acquiror has borrowed third-party debt externally and has used the proceeds of the borrowing to acquire shares of the target (as, for example, in a standard leveraged buyout). In the context of a public company acquisition, an acquiror may borrow acquisition financing through a syndicate of lenders. If it happened that a specified shareholder of

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63 Proposed clause 88(1)(c.4)(ii)(B).

64 Subparagraph 88(1)(c.4)(ii). Also, as discussed above, indebtedness of a grandparent that is a taxable Canadian corporation may be specified property pursuant to subparagraph 88(1)(c.4)(iv) (see supra note 25).

65 It is assumed that such borrowing is part of the series.
the target (or other prohibited person) was also a member of the lending syndicate, the bump would not be available because a prohibited person would have acquired prohibited property as part of the series. As a result, in acquisitions where reliance has been placed on the availability of the bump (for example, for valuation purposes), it has become practice for the acquirer to seek confirmation from potential members of the lending syndicate regarding their share ownership, if any, in the target.

The legislative proposals eliminate the need for these precautions. Proposed clause 88(1)(c.4)(ii)(B) provides that indebtedness that was issued for consideration that consists solely of money will be specified property. Thus, acquisition financing, assuming that it is issued solely for money, will constitute specified property. On its face, this proposal includes convertible debt or other participating debt issued solely for money as specified property. However, consideration should be given to whether such debt may constitute determinable property. In such case, it may be prohibited property.

The technical notes to the legislative proposals suggest that the amendment applies to indebtedness issued by the parent for consideration that consists solely of money, but the proposed amendment is not, on its face, limited to indebtedness of the parent. For example, indebtedness issued by a non-resident acquiror solely for cash consideration, the proceeds of which are used to capitalize a Canadian acquisition corporation, would be specified property under the legislative proposals. Obviously, a more comprehensive inclusion of indebtedness in specified property provides greater flexibility for taxpayers in financing acquisitions and ongoing operations.

Stock Options

The legislative proposals also address stock options, which are another category of substituted property that is usually relevant in the context of public company targets. Stock options are a common form of employee compensation intended in part to align employees’ interests with those of shareholders. An acquirer may seek to have new or continued equity participation by employees through the issuance of employee stock options at the level of the acquiror or other upstream entity. Typically, new options in respect of shares of the acquiror (or other upstream entity) would be issued to employees, or alternatively, existing employee stock options held by employees could be rolled into options of the parent corporation in a transaction that satisfied the requirements of subsection 7(1.4). In such a transaction, the existing employee stock options would be disposed of (that is, cancelled), and, in exchange, the optionholders would receive new options in respect of shares of the acquiror having an equivalent in-the-money amount to that of the cancelled options.

Since the value of the options (in either case) would be attributable to underlying distributed property of the target, the options would constitute substituted property. Options may be particularly problematic in determining the availability of the

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66 Supra note 60, at 266.
67 Proposed paragraph 88(1)(c.9).
bump since optionholders may also be existing target shareholders (for example, from the past exercise of stock options). If an employee was an existing specified shareholder of the target, the issuance to that employee of an option for shares of the acquiror would preclude the bump. Thus, the impact of the receipt of substituted property (the newly issued stock options) by employees on the availability of the bump must be considered. While it is unlikely that an individual employee would be a specified shareholder of a public company, the aggregation rules discussed above must be considered in analyzing the bump denial rules.

In the past, the Department of Finance issued a number of comfort letters in response to taxpayers’ requests that the definition of specified property be expanded to include options. In those requests, taxpayers suggested that because the options were proxies for the shares to which the option related, if such shares would be specified property, the related options should be specified property. In the comfort letters, the department agreed that an option exchange should not in itself result in denial of the bump, and stated that it was prepared to recommend that the Act be amended to ensure that rights to acquire shares would not constitute substituted property.

However, the legislative proposals do not directly adopt the approach advocated by taxpayers in their requests. Rather, new proposed paragraph 88(1)(c.9) provides that for the purposes of the definition of specified property, a reference to a share of a corporation includes a right to acquire a share of the corporation (that is, an option). At first blush, this approach may seem appropriate on the basis that an option should constitute specified property only if the share to which the option relates is specified property. Presumably, in drafting this proposed amendment, the Department of Finance was concerned that only options in respect of shares that are specified property should be specified property (excluding, for example, options in respect of shares of a foreign acquiror).

Technically, however, the proposed amendment provides no relief if an option exchange is structured in a manner that is typical in the context of an acquisition of a target corporation. If the options in respect of shares of the target are cancelled by the target and, in exchange, options of the acquiror are issued to the former target optionholders, there is no category of specified property that will include such options. The relevant references to “shares” in the definition of specified property in paragraph 88(1)(c.4) specify shares of the parent that are received as consideration for the acquisition of shares of the target, or shares of the parent that are issued for consideration that consists solely of money. Neither of these exceptions will be satisfied if a reference to a share in paragraph 88(1)(c.4) includes an option. In the

68 See, for example, Department of Finance comfort letters dated April 22, 2002; June 24, 2003; and April 15, 2005.

69 Also included, pursuant to subparagraph 88(1)(c.4)(iv), are shares of a taxable Canadian corporation received as consideration for the acquisition.
typical arrangement described above (where new options are issued to the employees), the new options will not be issued as consideration for the acquisition of options (or shares) of the target by the parent or for consideration that consists solely of money. Similarly, if the new options are issued in an option exchange under subsection 7(1.4), the new options will not be received as consideration for the acquisition of the existing options (or shares) by the parent. Rather the existing options will be cancelled. Further, the new options clearly will not be issued for consideration that consists solely of money in an option exchange intended to comply with subsection 7(1.4).\(^{70}\) In order to fit within the legislative proposals, the acquiror would have to acquire the existing options and issue new options in exchange therefor. Presumably the existing options held by the acquiror could then be cancelled. While this may be feasible, it is a departure from existing practice.

In its submission in respect of the December 12 draft legislation, the joint committee noted deficiencies in respect of proposed paragraph 88(1)(c.9). In particular, the joint committee noted that because stock options are compensatory in nature, such property should per se constitute specified property, including stock options in respect of shares of a non-resident corporation. These concerns are not addressed in the more recent legislative proposals. Instead, the December 2012 draft of the amendment remains unchanged.

**Other Proposals Addressing Prohibited Property**

The legislative proposals introduce a rule that provides that distributed property is deemed not to have been acquired by a person if it was acquired prior to the acquisition of control but is not owned at any time after the acquisition of control.\(^ {71}\) The comfort letter to which this proposal responds\(^{72}\) does not reveal much detail about the specific transactions in issue. However, it seems clear that if the distributed property is not owned by the prohibited person at any time after the acquisition of control, the acquisition of the property (prior to the acquisition of control) should not be relevant to the availability of the bump.

The legislative proposals expand the circumstances in which shares issued in an amalgamation squeeze-out will qualify as substituted property. In an amalgamation squeeze-out, assuming that a sufficient quantity of shares has been tendered to a bid, the target will amalgamate with a new corporation and issue redeemable preferred shares to minority shareholders that have not tendered to the bid. The preferred shares will be immediately redeemed to squeeze out those minority shareholders. Under the current law, for the preferred shares issued on the amalgamation squeeze-out to constitute specified property, the shares would have to be redeemed for cash. In response to taxpayers’ concerns, under the legislative proposals, the preferred shares

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70 Paragraph 7(1.4)(c).
71 Proposed subparagraph 88(1)(c.2)(iv).
72 Department of Finance comfort letter dated September 1, 2006.
may instead be redeemed for consideration that includes shares of the parent.\textsuperscript{73} The Department of Finance had indicated in prior comfort letters that since shares of the parent would be specified property if issued directly to shareholders, it should be possible to issue such shares to shareholders on an amalgamation squeeze-out.\textsuperscript{74} As a result, there should be greater flexibility in structuring such transactions.

**Specified Persons and Specified Shareholders**

The legislative proposals relevant to the concepts of specified persons and specified shareholders are narrowly focused. In the context of the definition of a specified person, the proposals contain a rule that is intended to be relieving in circumstances in which the bump parent is a newly incorporated corporation.\textsuperscript{75} In the context of the definition of a specified shareholder, the proposals contain amendments that address technical issues that arise where a target shareholder has a controlling shareholder.\textsuperscript{76} These changes are discussed in turn below.

**Specified Person**

Specified person status is generally tested under subparagraph 88(1)(c)(vi) at the time of the acquisition of distributed or substituted property. Since the bump parent will frequently be a new Canadian acquisition corporation, and specified person status is defined by reference to the bump parent, it is prudent to incorporate the bump parent as early in the series as possible in order to impart specified person status to related persons. Proposed clause 88(1)(c.2)(i)(C) is intended to provide relief in this regard by permitting a person to be a specified person before the incorporation of the bump parent. The proposal provides that if the time is before the incorporation of the bump parent, each person that is related to the bump parent throughout the period that begins at the time that the parent is incorporated and ends at the time that is immediately before the winding up of the target is a specified person. Thus, the legislative proposals extend what would otherwise be a point-in-time test (applied at the time of acquisition of the relevant property) to a throughout-the-period test. This difference likely will not be of concern from a practical perspective. However, unless there is a compelling reason to the contrary, it may still be prudent to incorporate the bump parent as early in the series as possible, so that all related persons are clearly specified persons at the time that any substituted property is acquired.

The joint committee noted in its submission that there are deficiencies in the drafting of clause 88(1)(c.2)(i)(c) in that no person can be related to the parent corporation at the time that it is incorporated; shares of the parent must first be issued in

\textsuperscript{73} Proposed subparagraph 88(1)(c.4)(v), which also combines existing subparagraphs 88(1)(c.4)(v) and (vi).

\textsuperscript{74} See Department of Finance comfort letters dated May 2, 2002 and January 20, 2006.

\textsuperscript{75} Proposed clause 88(1)(c.2)(i)(B).

\textsuperscript{76} Proposed clauses 88(1)(c.2)(iii)(A.1) and (A.2).
order for a person to become related. On this interpretation, the legislative proposal would never have application. However, there is a principle of statutory interpretation against such a reading of the provision. The legislative proposals in this regard are unchanged from the December 2012 draft legislation.

**Specified Shareholder Status**

The legislative proposals also contain amendments to the definition of a specified shareholder applicable for the purposes of the bump denial rules. These amendments give effect to various comfort letters issued by the Department of Finance. As noted above, they are narrowly focused to address technical issues that arise in circumstances where a target has a controlling shareholder.

Recall that, under the definition of a specified shareholder, a taxpayer is deemed to own each share of a corporation that is owned by a non-arm’s-length person. This rule is appropriate in the context of aggregating shareholders within a corporate group to determine specified shareholder status of members of the group. However, anomalous results can arise in circumstances where there is a controlling shareholder of the target or of the acquiror. If the target has a controlling shareholder, all controlled subsidiaries of the target will be specified shareholders of the target. That is, because a subsidiary of the target will be deemed to own all shares held by any non-arm’s-length persons, including those held by the controlling shareholder, the subsidiary will be a specified shareholder of the target. (This issue does not arise if the target is widely held because in this situation, the subsidiaries of the target will not be dealing at non-arm’s-length with the shareholders.) If the shares of the subsidiary are then sold to an unrelated purchaser that has a controlling shareholder, the subsidiary will also be a specified shareholder of the purchaser for the same reason (that is, the subsidiary and the controlling shareholder of the purchaser will not be dealing at arm’s length and, as a result, the subsidiary will be deemed to own the shares of the purchaser held by the controlling shareholder and will be a specified shareholder of the purchaser). This is not an unusual or contrived fact pattern; frequently, the purpose of a bump transaction is to sell the shares of a subsidiary to a third-party purchaser. However, the bump is denied under the current law because a corporation (the purchaser) of which a specified shareholder of the target (the subsidiary) is a specified shareholder has acquired bumped property (the shares of the subsidiary).

The legislative proposals address this unintended result by providing that a corporation (the subsidiary in this example) controlled by another corporation (the target) is deemed not to own shares of the other corporation (the target) if the corporation (the subsidiary) does not have a direct or indirect interest in any shares of

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77 It is generally presumed that Parliament could not have intended an absurd result. See, for example, *Grunwald v. Canada*, 2005 FCA 421.

78 See supra note 37 and the accompanying text.

the other corporation (the target). Because a subsidiary does not have a direct or indirect interest in the target, the subsidiary will not be deemed to own the shares of the target owned by the controlling shareholder. Thus, the subsidiary will not be a specified shareholder of the target. While the proposal addresses this anomalous result (which was discussed in an earlier comfort letter), it does so in a very focused manner. The relevance of the legislative proposal is largely limited to this particular fact pattern.

Another narrow amendment introduced in the legislative proposals addresses another anomalous result. Where a sale of the shares of a subsidiary of the target to a third-party purchaser is contemplated prior to the acquisition of the target, the purchaser may have entered into the agreement to acquire the shares of the subsidiary in advance and therefore may be related to the subsidiary pursuant to paragraph 251(5)(b). A corporate controlling shareholder of the target will also be related to the subsidiary. Under subsection 251(3), where two corporations (in this case the purchaser and the controlling shareholder) are related to the same corporation (in this case the subsidiary), the two corporations are deemed to be related to each other. Consequently, the third-party purchaser and the controlling shareholder will be related, causing the purchaser to be a specified shareholder of the target (since it will be deemed to own the shares of the target held by the controlling shareholder, a non-arm’s-length person). In this situation, the bump will be denied because a specified shareholder of the target (the third-party purchaser) has acquired distributed property (the shares of the subsidiary).

Under the proposed amendment, a person is not deemed to own shares of the target held by non-arm’s-length persons where the non-arm’s-length relationship arises only because the person has a paragraph 251(5)(b) right to acquire shares of a subsidiary of the target that does not have a direct or indirect interest in the target. Specifically, paragraph (a) of the definition of “specified shareholder” in subsection 248(1) is to be ignored in respect of shares of the target if the person would be deemed to own such shares only because of a paragraph 251(5)(b) right to acquire shares of a corporation controlled by the target (that does not have a direct or indirect interest in the target). Thus, under the legislative proposals, the purchaser would not be deemed to own the shares of the target (held by the parent) and thus would not be a specified shareholder of the target prior to the acquisition of control. While the legislative proposal addresses this specific technical issue (also discussed in an earlier comfort letter), it does so in a very narrow fashion. As a result, the relevance of the proposal will largely be limited to the fact pattern at which it was directed.

80 Proposed clause 88(1)(c.2)(iii)(A.1).
82 Proposed clause 88(1)(c.2)(iii)(A.2).
CONCLUSION

The bump denial rules are among the most complex in the Act. In this regard, the aggregation rules, as well as the application of the rules in respect of partnerships, can give rise to uncertainty. However, problems with the current law can be traced largely to the broad scope of the provisions defining property that cannot be acquired by specified shareholders (and other prohibited persons) as part of the series. This issue has necessitated successive changes to the bump denial rules in the form of relieving provisions and other technical amendments. As relieving measures, the most recent legislative proposals will, of course, be of benefit to taxpayers.

In particular, the changes to the definitions of substituted property and specified property will be welcomed by taxpayers. The introduction of a safe harbour into the definition of substituted property should reduce some of the complexity in analyzing the availability of the bump. While the proposal does open up the possibility that shares of a foreign acquiror may be used as consideration in an acquisition in which the bump is sought, it does so quite narrowly, since the amendment requires that the Canadian target comprise 10 percent or less of the foreign acquiror. With the introduction of comprehensive rules directed at base erosion,84 it is perhaps time to revisit the restriction on the use of shares of a foreign parent as consideration in a bump transaction. The introduction of an exception for indebtedness issued solely for money is another change that should reduce uncertainty in determining the availability of the bump. The amendment should eliminate the need to seek confirmation of the ownership interests of members of a lending syndicate in the target, in support of the availability of the bump. While establishing the status of stock options as specified property in some cases has been facilitated by the legislative proposals, on the basis of comfort letters, a more comprehensive rule providing that employee stock options generally constitute specified property might have been expected. From a policy perspective, at least with respect to public company employee stock options, it would seem acceptable from a policy perspective for employees that are not specified shareholders to receive new options in connection with an acquisition.

The legislative proposals also address some longstanding technical issues that arise where a target or third-party purchaser of distributed property has a controlling shareholder. The changes address the technical issues in a narrow and specific manner, rather than scaling back some of the expansive provisions that gave rise to those issues. As a result, it is likely that other technical issues will emerge that will have to be addressed through further amendments.

84 See supra note 29 and the accompanying text.

The author of this paper describes the United States as a tax haven and challenges it to help developing countries by ceasing to be one.

According to the author, several tax rules make the United States an attractive place for foreigners to invest and hide their money. These rules include the zero withholding tax rate on portfolio interest payments to non-residents and the non-taxation of capital gains realized by non-residents who dispose of financial assets in the United States. But the principal rule is the revenue rule, which prohibits the United States from recognizing and enforcing foreign tax judgments. Under this rule, if a foreigner hides money in the United States and fails to pay taxes at home, her government cannot satisfy the tax debt with the taxpayer’s US assets. The hidden money disparately affects developing countries. The United States has functioned as a repository for foreign assets. For example, by 2011 about $240 billion in Latin American wealth found its way into the United States, ending up primarily in Miami and New York. In 2009, the United States topped the list of countries that served as homes for private foreign deposits.1

The author notes an interesting phenomenon: while the United States causes foreign governments to lose tax revenue because their taxpayers use it as a tax haven, the United States is also the victim of an estimated $40 to $70 billion loss in tax revenue because American taxpayers use offshore tax havens.2 The United States has attempted to combat the use of tax havens through unilateral measures, such as the Foreign Account Tax Compliance Act (FATCA) and bilateral information exchange agreements, and through multilateral efforts spearheaded by the Organisation for

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1 At 9-10.
2 At 3.
Economic Co-operation on Development (OECD), and it does not seem to mind practising economic imperialism. In contrast, the United States chose to do nothing about the fiscal damage to other countries; it does not want to enforce foreign revenue judgments because it does not want to impinge on foreign sovereignty and risk being seen as practising economic imperialism.

The author argues that the revenue rule is not grounded in any compelling policy considerations. It stands in stark contrast to the general default rule that US courts will enforce foreign final judgments. According to the author, the United States should revoke the revenue rule, both from a moral obligation to aid developing economies in becoming self-sufficient and from a practical desire to receive reciprocal aid in collecting taxes that are being held overseas.

J.L.


Capital income is inherently mobile. Taxing capital income is very difficult, especially for developing countries. The author of this article sees the emerging international information exchange regime, triggered by FATCA, as an opportunity for emerging countries to have the means of taxing capital income earned by their residents.

The author first provides an overview of FATCA, which was enacted by the United States to address its concerns about tax evasion by US taxpayers who hold assets in accounts with foreign financial institutions. FATCA requires foreign financial institutions to report the account balance or value of each US account and the amount of dividends, interest, other income, and gross proceeds from the sale of property credited to a US account. A US account is one held by US individuals and shell entities owned by US individuals. In order to force foreign financial institutions to disclose their US account holders or pay a steep penalty for non-disclosure, FATCA imposes a withholding tax on specified payments from US sources and the proceeds from disposing of certain US investments on foreign financial institutions that do not comply by becoming a participating foreign financial institution. The United States used the combined weight of its financial markets and the need of financial institutions to do business in the United States as leverage to ensure that foreign financial institutions comply with FATCA reporting requirements. The desire to obtain tax information from foreign financial institutions is shared by many other countries, but none has the clout enjoyed by the United States.

In part I of the article, the author explains that compliance with the unilateral law of the United States was problematic for foreign financial institutions because they had to choose between violating FATCA and violating their domestic laws that protect bank secrecy. This problem was resolved with a model intergovernmental agreement (model 1 IGA) developed by the United States and some EU countries (France, Germany, Italy, Spain, and the United Kingdom) on the basis of reciprocal automatic information exchange between governments. According to the article, “[a] number of technical features of the Model 1 IGA agreement are structured to allow FATCA to
become a global model.”3 However, one of the obstacles blocking model I IGA from becoming a global model was the United States itself. The model I IGA provides for only partial reciprocity between the United States and its partners: the US obligation to report is limited to those types of accounts on which the United States has authority to collect information under current US laws and regulations, whereas its partners are required to collect information on all income earned through financial accounts that are held by the US persons specified by FATCA. Therefore, when the United States and Switzerland agreed to facilitate FATCA compliance, the reciprocal automatic information exchange between governments was modified. It provided for direct reporting by Swiss financial institutions to the Internal Revenue Service (IRS), with consenting US account holders reported on individually and non-consenting US account holders reported on an aggregate basis. Switzerland then agreed to provide information exchange on request about ascertainable groups of non-consenting US account holders. This model is referred to in the article as “Model II IGA.” In part I of the article, the author argues that the recent trends in addressing offshore accounts may produce a fragmented automatic information reporting system that benefits only a limited number of developed economies.

In part II of the article, the author argues that only a uniform multilateral automatic information exchange regime can benefit emerging countries because these countries lack sufficient independent leverage over multinational financial institutions to address their offshore tax-evasion concerns. And, interestingly, such a regime also benefits financial institutions. Major multinational financial institutions have emphasized their desire for a universal model to implement FATCA, including consistent compliance requirements and reporting frameworks.

In part III, the author notes the recent global developments in creating a single global model for automatic tax information exchange and attributes them to FATCA: “FACTA is a catalyst that forces the world to search for something better than FATCA itself, which can effectively replace it while also addressing the underlying policy concerns.”4 In part III, the author maintains that a uniform multilateral automatic tax information exchange regime is a subset of international financial law. A regime that could be useful to emerging countries will materialize only if the G20 plays an agenda-setting role and the OECD provides the technical expertise. The author suggests steps that emerging countries may take in bilateral and multilateral settings to help create the requisite governance structure.

3 At 333.
4 At 352.

Tuition, education, and textbook credits (student credits) are an important part of student aid. Neill’s calculations show that the tax savings for a full-time university student amount to more than $2,000 per year in all provinces except Ontario and British Columbia; these savings amount to 31 to 43 percent for an average $6,000 tuition fee. Neill implies that the size of these savings is fully justified by the goal of economic efficiency because of the spillover benefits of education to society and students’ inability to finance their educational investments by borrowing (since investments in education, unlike investments in a house or a factory, do not result in something that can be sold). Nevertheless, Neill concludes that the current system of student credits is “one of the least effective and least equitable ways of achieving those aims.”

One reform would be to make these credits refundable so that they could be used immediately by the low-income students who need them the most. However, although it is well known that the major barrier to refundability is revenue cost, Neill chooses not to investigate this issue, commenting only that “[t]his cost would be fairly minor, however, and [would] only last for a few years at the most.”

Neill’s bigger point is that behavioural economics research suggests that the whole concept of delivering student benefits through tax credits is inappropriate because it is unlikely to increase enrolment from youth in low- to middle-income families. One reason is that it is difficult to determine tuition credits net of the tax savings benefits; even tax practitioners would probably not know that the total federal and provincial tax savings from student credits is highest in Alberta ($2,596) and lowest in British Columbia ($1,843). In addition, the delay in receiving the cash payment (often longer than six months after tuition fees have been paid, and much longer than that if neither the student nor the student’s parents can use the credit in the current tax year) makes tax credits worth less in present value terms. Low- and middle-income students are likely to use especially high discount factors in evaluating future benefits. Further, much of the student credits go to high-income families, and students from these families are unlikely to change their education enrolment plans on the basis of the credits.

What then is the alternative? Neill looks favourably on the Quebec government’s choice to reduce the tuition tax credit rate from 20 to 8 percent, with the savings going to increase provincial student aid. Neill also suggests considering having the government make direct deposits into registered educational savings plans for 14- to 17-year-old high school students.

A.M.

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5 At 4, table 1.
6 At 18.
7 At 19.
8 At 4, table 1. The figures are for the 2012 tax year.

The theme of behavioural economics is that decision makers often fail to be rational in the economic sense; for example, they show biases and inconsistencies in their thought patterns. However, the effects of this non-rational behaviour are reduced in the case of privately purchased goods because the goods are purchased in competitive markets. Although it would not be difficult for an individual seller to trick many consumers into thinking that a fair price is quite a bit higher than it is in reality, competition in markets drives the price down and reduces the impact of these seller-induced biases. Effectively, markets give power to the few who are not fooled.

McCaffery emphasizes that there is no such de-biasing mechanism in tax and public finance, and therefore the lessons of behavioural economics should be more powerful in this arena than in the case of privately purchased goods. For example, one study found that consumers fail to appropriately reduce their consumption of a good that is subject to a tax imposed at the cash register, even when information about the added tax is widely available.9

Unfortunately, few studies currently apply the principles of behavioural economics to public finance. Thus, McCaffery devotes much of his paper to speculations about how behavioural economics could explain the self-created “fiscal cliff” crisis in the United States, and the general problem that in many countries political processes consistently lead to government revenues falling below government expenditures.

A.M.

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Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, “Re: Draft Legislative Proposal Released by the Department of Finance on June 3, 2013,” submission to Brian Ernewein, General Director, Tax Policy Branch, Tax Legislation Division, Department of Finance, December 2, 2013, 9 pages

Joint committee submissions are often of ephemeral interest since the comments typically concern technical fixes to legislation that are of minor importance for most taxpayers and do not raise broad policy issues. However, this submission is an exception.

In the 2013 budget, the government proposed taxing all testamentary trusts at the top marginal rate and taxing estates at that rate after the first 36 months of administration, essentially eliminating the tax advantage that testamentary trusts and estates

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enjoyed over inter vivos trusts. The committee rejects this proposal, arguing that it will cause taxpayers to hurry property through a trust or estate for tax reasons and thereby frustrate non-tax objectives (for example, in the case of a testamentary trust that lasts until a young adult beneficiary is able to manage the assets). The committee prefers the status quo, but, if something has to be done, it favours an amendment to the principal beneficiary exemption to solve the testamentary trust issue and a generally worded anti-avoidance rule for estates in place of the 36-month bright line.

The submission contains much valuable information on the purpose of a testamentary trust, the history of the taxation of trusts (including a review of the Carter commission’s analysis from 1965), and the application of the tax policy principle of neutrality to trusts and estates. It was surprising that the government did not include this sort of valuable background material in the budget or in its woefully short June 3, 2013 consultation paper, which consisted of fewer than 2,000 words.10

A.M.


Cryptocurrencies are a subcategory of virtual currencies. One type of virtual currency that is getting a lot of attention is Bitcoin. Bitcoin functions as a unique currency with its own free-floating exchange. Over the past few years, Bitcoin gradually gained the confidence of consumers, retailers, and service providers, and it is now effectively functioning as a currency in the real world. In August 2013, Germany officially recognized Bitcoin as a legal form of tender. Other countries, such as Canada, China, and the United States do not officially recognize Bitcoin as a legal form of tender but recognize its use in the private sector. Recently, a US federal judge ruled that Bitcoin is money for the purposes of US securities regulation.

In this article, the author links the increasing popularity of cryptocurrencies to the ongoing debate about international tax evasion and fraud through the use of tax havens. The author maintains that cryptocurrencies have the potential of functioning as “super tax havens.” They not only possess the traditional characteristics of tax havens (non-taxation of income and anonymity of taxpayers) but also offer an additional advantage to their users: their operation is not dependent on the existence of financial institutions. Any anti-evasion and anti-avoidance measures that depend on financial institutions for information reporting or withholding of taxes would be rendered ineffective.

10 Canada, Department of Finance, Consultation on Eliminating Graduated Rate Taxation of Trusts and Certain Estates (Ottawa: Department of Finance, June 3, 2013).

11 Michigan Law Review First Impressions is an online companion to the Michigan Law Review, and publishes op-ed-length articles by academics, judges, and practitioners in an online symposium format.
The author discusses the convergence of two processes: the increasing popularity of Bitcoin and an emerging global process requiring financial institutions to become “agents in the service of tax authorities.” The latter process was triggered by the US FATCA initiative. Financial institutions “face increased governmental pressure to deliver information about account holders, to withhold taxes from earnings accumulating in financial accounts, and to remit these taxes to taxing authorities around the world.” Examples include the actions taken by G7 governments against financial institutions as part of recent attempts to tax offshore accounts. The author observes that cryptocurrencies can defeat the development of a meaningful global tax enforcement regime. In light of the fact that Bitcoin can be used by legitimate businesses as well as illegitimate businesses, Bitcoin-based tax evasion may soon become a real problem. Tax evaders and money launderers can use Bitcoin to hide the sources as well as the destination of funds.

The author urges tax policy makers to take cryptocurrency-based tax problems seriously because the use of Bitcoin is not limited to virtual transactions; Bitcoin is increasingly used as real money to purchase real goods and services in the real world. Indeed, the growth potential for cryptocurrencies and super tax havens is, in theory at least, infinite. Governments are urged to develop enforcement mechanisms that allow tax authorities to discover funds hidden in cryptocurrency accounts.

J.L.


Is public shaming or tax privacy more effective in encouraging tax compliance and deterring non-compliance? The author of *United States National Report on Tax Privacy* describes the current US tax privacy protections, provides an overview of the policy debates over whether tax privacy promotes individual tax compliance, and advances a new ground for supporting tax privacy.

The author traces the interesting history of the current US tax privacy rules, which prohibit the government from publicly releasing the details of any specific taxpayer’s tax return or audit history unless the taxpayer consents. In 1862, when the US Congress first instituted income tax to pay for the Civil War, it required the names of taxpayers and their tax liabilities to be open to public inspection. When public support for income tax waned after the war, Congress prohibited the publication of income tax return information in 1870, just before the repeal of the income tax itself.

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12 At 39.
13 At 39.
When income tax was reintroduced in 1913, tax returns were public. The press gave extensive coverage to tax return information, especially information concerning prominent people (such as J.D. Rockefeller, Henry Ford, J.P. Morgan, and Charles M. Schwab) and Hollywood icons (such as Douglas Fairbanks, Charlie Chaplin, and Gloria Swanson). Secretary Andrew Mellon and President Calvin Coolidge vigorously opposed the publication of tax return information. In 1926, Congress enacted a new statute, requiring the publication of lists of names and addresses but not tax liabilities. The stock market crash and Great Depression of 1929 caused Congress to consider public access to income tax returns once again as a way of preventing tax evasion and the exploitation of tax loopholes. In 1934, the law required pink slips (containing the taxpayer’s name, address, total gross income, total deductions, net income, total credits, and tax liability) to be open to public inspection. This law was repealed the next year following a surge of public outcry. President Nixon apparently requested tax audits of political opponents and members of his enemies list, but the commissioner of the IRS refused to comply. In response to abuses that occurred during the Nixon administration, the current privacy law was enacted.

The IRS is authorized to share a taxpayer’s information in certain circumstances; it may, for example, share this information with state tax authorities and foreign tax authorities pursuant to a tax treaty. It is also authorized to publicize examples of strong tax enforcement against specific taxpayers. With the help of the news media, the IRS is able to inflate taxpayers’ perceptions of two principal motivators for deterrence: the probability of detection and the costs of non-compliance. Without tax privacy, examples of weak tax enforcement against specific taxpayers would surface and have the opposite effect on individuals’ perceptions and tax compliance decisions. According to the author of the report, strategic publicity, a function of tax privacy, may also enable the government to increase confidence among compliant taxpayers that only a few of their fellow taxpayers cheat and that all cheaters face dire consequences.

It is beyond the scope of the report to discuss the recent global efforts in enhancing tax transparency. Readers of the report may wonder if this recent development would tip the balance of the debates toward more public access to taxpayer information, especially if the taxpayer is a multinational corporation.

J.L.


On October 16, 2013, the European Parliament released an amended text of a proposal for a regulation establishing an action program to improve the operation of taxation systems in the European Union from 2014 to 2020 (commonly known as
“fiscalis 2020”). The proposed fiscalis 2020 is intended to provide mechanisms, means, and the funding necessary to improve cooperation among tax administrations in the European Union. It is a continuation of the annual action program for taxation that contributed to facilitating and enhancing cooperation between tax authorities within the European Union. With a budget of €234.3 million, the program will run for seven years, beginning January 1, 2014.

The program will support a common highly secured dedicated communication network to allow the exchange of information. The common network interconnects national tax administrations from approximately 5,000 connection points. A national tax administration needs to connect once to this network to be able to exchange any kind of information. Furthermore, fiscalis 2020 allows for agreements to be concluded with third countries, allowing them to use the EU components of the information systems to support a secure exchange of information between themselves and EU member states in bilateral tax agreements.

Similar to FATCA in the United States, fiscalis 2020 also focuses on supporting the fight against tax fraud, tax evasion, and tax avoidance. In addition, it aims at reducing administrative burdens for tax administrations and compliance costs for taxpayers. To achieve these objectives, fiscalis 2020 will facilitate networking, joint actions, and training among tax personnel and fund technological systems to support the exchange of information among tax administrations.

Fiscalis 2020 is an ambitious program. It is an important step in creating an international regime that enables national tax authorities to share tax information and cooperate with one another in enforcing national tax laws, EU tax laws, and tax treaties.

J.L.


In this report, the International Bar Association Task Force addresses international tax abuse from the perspective of human rights law, focusing on illicit financial flows, poverty, and human rights.

The report contains two explanations for the recent public spotlight on tax abuses. One is the sheer magnitude of the issue: tax abuses are thought to cause the most significant illicit financial flow out of the developing world, eclipsing the amount of official development aid. Another explanation involves an ethical dilemma: sophisticated tax-planning strategies result in individuals and corporations not paying their fair share of tax. The task force states:

Especially in a context of persistent poverty and rising inequality between and within nations, the fact that tax strategies that produce unfair results may be technically legal is no longer a sufficient justification for their continued use. Wealthy individuals and
multinational enterprises face increased risks of public censure if their tax practices are seen to be abusive.\textsuperscript{14}

According to the task force, the term “tax abuses” describes tax behaviour that

(a) was of greatest concern to stakeholders interviewed; and (b) potentially has the most significant impacts on the ability of developing countries to reduce poverty and satisfy basic human rights recognised by the International Covenant on Economic, Social and Cultural Rights. They include tax evasion, tax fraud and other illegal practices—including the tax losses resulting from other illicit financial flows such as bribery, corruption and money laundering.\textsuperscript{15}

In addition, the task force seems to regard the following behaviour as abusive:

- Corporate profit-shifting, especially transfer mispricing.
- Lobbying by businesses and elites for tax holidays and exemptions.
- Inadequate taxation of natural resources.
- The use of offshore investment accounts.\textsuperscript{16}

On the basis of extensive consultation with people of diverse perspectives, the task force concludes that there is a link between tax abuse, poverty, and human rights. Multinational enterprises that engage in tax abuse (specifically, illegal tax evasion and aggressive tax avoidance) as well as governments that fail to take steps to curb these practices may be violating international human rights. The task force states, “Simply put, tax abuses deprive governments of the resources required to provide the programmes that give effect to economic, social and cultural rights, and to create and strengthen the institutions that uphold civil and political rights.”\textsuperscript{17}

The task force also comments, “Actions of states that encourage or facilitate tax abuses, or that deliberately frustrate the efforts of other states to counter tax abuses, could constitute a violation of their international human rights obligations, particularly with respect to economic, social and cultural rights.”\textsuperscript{18} The task force cites offshore tax havens with strong banking secrecy as facilitators of human rights violations.

Lawyers have a special role in addressing tax abuses. . . . Merely complying with tax law is not enough when this results in the violation of human rights. Responsibility for human rights includes situations where lawyers are associated with third parties’ actions that violate human rights—including by their clients. In such situations, lawyers

\textsuperscript{14} At 1.
\textsuperscript{15} At 24-25.
\textsuperscript{16} At 26.
\textsuperscript{17} At 93.
\textsuperscript{18} At 148.
should use their influence and leverage to encourage their client to not engage in that conduct.¹⁹

The task force recognizes that few human rights mechanisms can deal effectively with tax abuses. However, several United Nations mechanisms have the mandate and potential to articulate the links between tax abuses, poverty, and human rights on an authoritative basis. The task force suggests that a human rights perspective on the debate about tax abuses is important for developing coherent international standards and good practices for states, multinational enterprises, and their advisers and financiers.

This perspective will surely generate some interesting debate about tax abuse and the future development of international tax systems.

J.L.


The authors of this forthcoming article present an interesting perspective on the debate about tax evasion and tax abuse. They challenge the allegations by political leaders and others that offshore financial centres enable multinational enterprises to avoid paying their fair share of taxes, resulting in $21 to $32 trillion being hidden and untaxed. The authors argue that these allegations rest on poor data and analysis and on profound misunderstandings of how financial transactions, international taxation, and anti-money-laundering rules actually work. They advise against increasing regulation without considering its cost and effectiveness.

According to the authors, policy makers view international money movements on a continuum: at one end are those who believe that these movements are illegitimate unless subject to strict public control; at the other end are those who believe that international money movements reflect the legitimate workings of the market and need no public controls; and in the middle are those who acknowledge that some public control is necessary to prevent abuse. In the view of the authors, much current commentary and actual public policy is too close to the end of the spectrum that advocates strict public control; they believe that international trade and investment is a public good and that keeping transaction costs when moving money is also a public good. Any control must be judged by its costs in relation to market efficiency and benefits.

The authors maintain that globalized finance inevitably allows for tax planning, which reduces the transaction costs of doing business across borders and limits tax revenue. They also acknowledge that globalized finance provides financial privacy, which is desirable in its own right as well as being a means of encouraging additional

¹⁹ At 4.
wealth creation. They believe that governments should act as “forward-looking gardeners,” whose main concern is not maintaining a fence to keep out marauders but rather improving the water supply, enhancing the fertility of the soil, and keeping a proper balance of sun and shade.

The authors explain that the global financial network is complex, serving legitimate as well as illegitimate purposes. The international tax system is also complex. Any international tax reform debate should be based on realistic cost-benefit appraisals and tradeoffs imposed by actual conditions rather than simplistic world views. One such actual condition is tax sovereignty.

J.L.


The 1923 League of Nations report by the “four wise men” is well known to anyone who is involved in international taxation. However, there has not been much literature on the background and intellectual debates that surrounded the writing of the report. This article fills that void. Its chronological narrative highlights the views of two of the report’s lead authors (Stamp and Seligman), the considerations that influenced each of them, and the compromises that were eventually reflected in the report itself. The author points out that even though the report has been credited with providing the theoretical foundation of the current international tax system, Stamp and Seligman considered practical issues and the likely inertness of economic forces in writing the report.

J.L.


Many observers have noted that both the Canadian and US tax systems treat employer-paid medical expenses and personally paid medical expenses inequitably; the latter are deductible only to the extent that they exceed a threshold (in Canada, the lesser of a dollar amount and 3 percent of income), while the former are completely non-taxable (in the case of private health services plans).

The standard proposal for correcting this problem is the elimination of the threshold from the medical credit. Johnson prefers to leave the threshold in place, apparently on the basis that smaller amounts of medical expenses are more likely to be voluntary expenses and thus less deserving of tax relief. Instead, Johnson proposes that employer-paid medical expenses should be non-taxable only if they are above the threshold. Similarly, employer-paid health insurance premiums should be a

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non-taxable benefit only if an insurer covered expenses above the threshold. Implementing this proposal in Canada would be more complicated than implementing it in the United States since either spouse can claim the couple’s medical expenses in Canada. Which spouse’s threshold should be used in determining non-taxability?

A.M.


This paper by staff economists at the OECD provides a valuable perspective on the recent economic crisis and its aftermath, with particular attention on tax policy.

It is well known that the initial economic contraction of late 2008 and early 2009 moved rapidly throughout the OECD countries and the rest of the world in the form of a fall in international trade, and that economic recovery has been slow. These patterns reflect the growing interconnectedness of economies. Further evidence of this interconnectedness is provided in the trends in budget deficits and public debt documented in this paper. Deficits as a percentage of gross domestic product (GDP) are still far larger than their pre-crisis levels in almost all countries. Another general pattern is that public debt in relation to GDP has increased dramatically in recent years, with the figure for all OECD countries increasing from 73 percent in 2007 to a projected 113 percent in 2014. Both of these combined trends are observable in Canada. In particular, Canada was almost alone in having a budget surplus in 2007 (over 1 percent of GDP) but has subsequently fallen into substantial deficit (over 2 percent of GDP).21

Another OECD-wide trend is that total tax revenue as a percentage of GDP has fallen from 2007 to 2011, largely as a result of a decline in taxes on income and profits: 1.2 percent for all OECD countries combined and 2.0 percent for Canada in particular.22 Subsequently, however, most countries increased tax burdens, leading to the austerity fatigue being felt in a number of countries. Canada is the exception because general government revenues as a percentage of GDP are expected to be lower in 2014 than in 2007.23 Nevertheless, Canada has followed the OECD pattern of increasing top personal income tax rates, although to a more modest degree than in most countries.

The authors note an unusual pattern in Canada regarding real (inflation-adjusted) house prices; these prices have fallen in most countries but have risen in Canada. Of the 20 OECD countries studied, Canada has the second highest average annual percentage change in real house prices (2004 to 2007 compared with 2008 to 2011).24

21 At 11, figure 3.
22 At 16, table 3.
23 At 15, table 2.
24 At 33, figure 19.
Another unusual fact about Canada is its low rate of environmental taxes: the average effective tax rate on carbon dioxide emissions is the third lowest among the 33 countries studied.25 Although the authors do not make this connection, these two facts suggest that one of the paper’s recommendations about tax policy would apply with particular force to Canada: greater use of environmental taxes and recurrent taxes on residential property could increase taxation in a way that would provide relatively little economic distortion.26 The reason for this lack of distortion with environmental taxes is that the taxes correct environmental externalities (for example, local air pollution as well as the worldwide effect on the level of greenhouse gases), while the similar reason with residential property tax is that the tax base may be less mobile internationally.

The authors note a wide divergence in environmental tax rates among countries, with Mexico, Canada, and the United States, all having rates of less than €10 per tonne of carbon dioxide, while the unweighted average of OECD countries is over €50 per tonne.27 Further, there is no indication of any trend toward convergence of effective tax rates. The authors suggest that the financial crisis may have diverted the attention of some countries away from the need to address climate change.28 Although the authors are too diplomatic to say so, coordinated North American action in this area over the next few years would be welcomed by most OECD countries.


This paper, by an OECD staff member, provides a quantitative comparison of the tax burden on four different types of capital income in the 34 OECD countries as of July 1, 2012. This information is difficult to get because it often requires consultation with the individual governments to ensure that fair comparisons are being made. The fact that this paper is an OECD publication suggests that the information is reliable. The four types of income and the key results for each (including Canada’s ranking in tax burden) are listed below.

1. **Equity investment in a domestic public company with the return flowed out to shareholders as dividends:** Canada has a tax rate of 50 percent, which is 8th highest of 34.29 Rates for OECD countries vary from 19 percent in the Slovak Republic to 61 percent in France, with an OECD simple average of 42 percent.30

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25 At 35, figure 21.
26 At 36.
27 At 35, figure 21.
28 At 34.
29 At 45, table 16.
30 At 7.
The calculation involves both corporate tax on income and personal tax on dividends.

2. *Equity investment in a domestic public company with the return accumulated as retained earnings and received by shareholders as a capital gain:* Canada has a tax rate of 44 percent, which is 13th highest of 34.31 Rates for OECD countries vary from 8 percent in Belgium to 60 percent in France, with an OECD simple average of 37 percent.32 The calculation involves both corporate tax on income and personal tax on capital gains.

3. *Interest income from cash deposits and government bonds:* Canada has a tax rate of 48 percent, which is 2nd highest of 34.33 Rates for OECD countries vary from 0 percent in Estonia to 50 percent in the United Kingdom, with an OECD simple average of 27 percent.34

4. *Capital gains realized on real property:* Canada has a tax rate of 24 percent, which is 13th highest of 34.35 Rates in OECD countries range from 0 percent in many countries (including France and Germany) to 45 percent in Denmark, with an OECD simple average of 14 percent.36

The above data show that Canada’s tax rate rankings tend to be high in relation to other OECD countries, with the tax rate on interest income being particularly notable. This reflects Canada’s relatively high reliance on personal income tax as a source of revenue, when compared with other OECD countries. It would be interesting to compare the above results with rankings for tax rates on labour income.

Predictably, many assumptions are required to ensure that the results are comparable across countries (fewer assumptions would probably be required to make a comparison among two or three countries). Generally, the authors compare the most basic type of income because more sophisticated types will generally have additional rules. The following are the key assumptions: only income taxes (not wealth taxes) are considered; the investor is resident in a particular country and is not related to the source of income; financial assets are held outside tax-preferred accounts (such as registered retirement savings plans); investors are taxable at the top of any progressive rate scale; and inflation adjustments (to tax only real gains) are not considered.37 For the two types of income that involve capital gains, the underlying asset is assumed to have been held for longer than the longest holding period specified in the country’s legislation. This last assumption tends to reduce

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31 At 45, table 16.
32 At 29.
33 At 45, table 16.
34 At 22.
35 At 45, table 16.
36 At 31.
37 At 5-6.
the calculated tax rates because assets held for longer than the time specified in a holding-period test are usually exempt from taxation.\textsuperscript{38}

Much of the paper is devoted to a description of the different tax systems that are applied in the 34 OECD countries to the four types of income. This description is not simply a list of countries and an overview of their tax systems; instead, the author analyzes the possible forms of taxation for each type of income and lists the countries that have these forms of taxation. It becomes apparent that Canada’s system for taxing dividends is most similar to Korea’s because the tax credit at the shareholder level is not dependent on the corporate tax paid, and that Canada’s system of including 50 percent of capital gains as regular income is most similar to Australia’s.

The variety of tax systems in the 34 countries is an eye-opener. Readers who have practised only within the Canadian system will have much to learn simply from the author’s descriptions.

A.M.

\textsuperscript{38} At 33.