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GAAR Revisited: From Instinctive Reaction to Intellectual Rigour

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PRÉCIS

Au cours des 25 ans qui se sont écoulés depuis l'entrée en vigueur de la règle générale anti-évitement (RGAE), les possibilités et les dangers de l'évitement fiscal ont suscité bien des débats. On traite beaucoup moins ouvertement des considérations subjectives qui touchent la résolution des cas sur la RGAE et de l'incertitude que créent de telles influences. Le présent article examine les aspects plus importants, mais moins concrets, de l'analyse de la RGAE. Il cherche à déterminer si les cas décidés jusqu'à présent peuvent être rationalisés de façon à révéler certains thèmes juridiques récurrents, bien que les décisions aient été prises dans des circonstances factuelles diverses. Les auteurs examinent la portée de la RGAE relativement aux principaux facteurs, objectifs et autres, qui ont façonné son application. En particulier, ils explorent une approche interprétative à la RGAE qui demeure ancrée dans la rigueur intellectuelle, même lorsqu'elle est influencée par une réaction instinctive.

ABSTRACT

In the 25 years since the general anti-avoidance rule (GAAR) came into effect, the possibilities and perils of tax avoidance have given rise to much debate. Less openly discussed are the subjective considerations that affect the resolution of GAAR cases and the uncertainty that such influences create. This article reviews the more significant, but less tangible, aspects of the GAAR analysis. It seeks to determine whether the cases decided to date can be rationalized so as to reveal certain recurring legal themes, even though the decisions were made in varying factual circumstances. The authors examine the scope of GAAR with reference to the driving factors, objective and otherwise, that have informed its application. In particular, they explore an interpretive approach to GAAR that remains grounded in intellectual rigour, even when influenced by instinctive reaction.

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The thesis of this article originated, in part, from a panel discussion on GAAR at the 2009 Canadian Tax Foundation annual conference. For a full transcript of that discussion, see Hon. Donald G.H. Bowman, Deen Olsen, Wayne Adams, Al Meghji, and Wilfrid Lefebvre, "GAAR: Its Evolution and Application," in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 2:1-23.

KEYWORDS: GAAR ■ TAX AVOIDANCE ■ ANTI-AVOIDANCE ■ STATUTORY INTERPRETATION ■ TAX PLANNING ■ TAX LITIGATION

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> *This is one of those paradoxes where the sheer complexity of the series of transactions involving many players tweaks the nose upward on that least scientific of analysis known, in tax vernacular, as the smell test, yet legislation and case precedent guide analysis down a more structured and deliberate path past the olfactory sense and into the more certain realm of reason, though less precise purview of policy, where the GAAR debate, in this case, rages.*
>
> *Canada Trustco Mortgage Company v. The Queen*, 2003 TCC 215, at paragraph 93, per Miller J.

INTRODUCTION

Last year marked the 25th anniversary of the general anti-avoidance rule (GAAR).[1] It is fair to say that our understanding of this rule has evolved over time. Although tax avoidance has long been a feature of the Canadian fiscal scene, its limits in relation to GAAR are far from well defined.

Long before GAAR was enacted, and since then, despite its overriding effect, taxpayers have been encouraged to capitalize on tax-saving opportunities.[2] The operating assumption has always been that such planning will be reviewed objectively by the courts, if not by the tax authorities. Courts have been hard pressed, however, to strike the perfect balance between regulating abusive practices and preserving certainty in tax planning.

1 Section 245 of the Income Tax Act, RSC 1985, c. 1 (5th supp.), as amended, came into effect on September 13, 1988.

2 *Lipson v. Canada*, 2009 SCC 1, at paragraph 21; and *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, at paragraph 65.

This struggle has borne itself out in the jurisprudence. Taxpayers have been told, on the one hand, to rely on the provisions of the Income Tax Act[3] and to take full advantage of the benefits that those provisions confer.[4] On the other hand, the courts have been equally clear that the application of GAAR requires the exercise of judgment,[5] and that "[t]his analysis *will* lead to a finding of abusive tax avoidance when a taxpayer relies on specific provisions . . . in order to achieve an outcome that those provisions seek to prevent."[6] In other words, there are limitations on what courts have considered to be effective, as opposed to merely clever, tax planning.

Confronted with such limitations, taxpayers have tended to perceive GAAR as imposing a degree of subjectivity, and even a measure of morality, in the tax-planning context. Underlying this perception is the unstated presumption that the application of GAAR is reactive in nature and not as rigorous as its terms would suggest. In short, the GAAR analysis essentially amounts to a glorified smell test.

The anniversary of GAAR presents an opportunity to set the record straight. To date, much has been said, and even more implied, regarding the variable nature of GAAR and the uncertainty that it exemplifies. What has routinely been taken for granted is that GAAR was never intended, nor has it operated, to impede legitimate tax planning on moral grounds or otherwise.

In any given GAAR case, the challenge lies in determining whether the underlying expectations of the law have been met in the context of enforceable legal relationships or whether those expectations have somehow been frustrated. The interpretive inquiry is one that must be conducted within the finite boundaries of the Act, with a view to establishing what the law truly means, not only by reference to what it explicitly says, but also in light of what it is intended to achieve in particular circumstances. It is therefore hardly surprising that intuition often is, and generally has been, a useful point of departure for the GAAR analysis.

In examining judicial responses to abusive tax avoidance, the focus has traditionally been on the "how" as opposed to the "why." Efforts have been made to reconcile apparent contradictions and to identify rules of general application, but the cases have rarely been analyzed as a reflection of judicial enterprise. This article endeavours to fill the gap. It examines, by reference to recent Canadian jurisprudence, the exacting but equally flexible framework within which GAAR cases are decided. Through this examination, it shows that developments in the jurisprudence have been as organic as the attitudes of those who render these decisions and that the application of rigour remains as reliable a safeguard as any to ensure certainty in tax planning.

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3 Supra note 1, herein referred to as "the Act." Unless otherwise stated, statutory references in this article are to the Act.

4 *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20, at paragraph 21; and *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, at paragraph 31.

5 *Lipson v. The Queen*, 2006 TCC 148, at paragraph 29.

6 *Canada Trustco*, supra note 4, at paragraph 45 (emphasis added).

The importance of rigour in the GAAR analysis suggests two of the central themes of this article. First, GAAR cases are fact-driven. They are not decided in the world of the abstract, and it is simply unrealistic to assume otherwise. Second, the interpretive process engaged by GAAR is fundamentally legal. A provision of this nature, although general in its scope, does not exist to override the law, but to ensure that its requirements have been satisfied. It is therefore incumbent upon those who view the GAAR analysis as a platform for moral guesswork to realize that there is a lot more to this provision than meets the eye.

This article also challenges common perceptions of the judicial function in the GAAR context. There is often a tendency to assume, particularly when applying GAAR, that the Act will reveal a coherent and uniform scheme of policies that can readily be construed. Like most other generalizations, this is only partly true. While there may be accepted approaches to interpreting the Act, in applying GAAR, courts are inevitably confronted with competing visions of the statute. It is precisely in this context that notions of equity can, and often do, influence the direction of GAAR cases. It nonetheless remains that such disputes must be resolved in a rigorous manner and on a principled basis.

STRUCTURAL OVERVIEW OF GAAR

GAAR embodies a very specific legal standard that must be met before a particular transaction or series of transactions will be considered to result in abusive tax avoidance. For GAAR to be engaged, there are three conditions that must be fulfilled:[7]

1. a "tax benefit" must result, directly or indirectly, from a "transaction" or series of transactions;[8]
2. the transaction(s) giving rise to the tax benefit must include an "avoidance transaction";[9] and
3. the outcome of the transaction(s) must reflect a misuse of the provisions relied upon or an abuse of the Act read as a whole.[10]

Tax Benefit

"Tax benefit" is broadly defined to include a reduction, avoidance, or deferral of tax or other amount payable under the Act. The threshold for determining the existence

7 The burden is on the taxpayer to refute the first and second requirements, and on the Crown to establish the third. *Canada Trustco*, supra note 4, at paragraphs 63-65.

8 The meaning of "tax benefit," as defined in subsection 245(1), is discussed below. A "transaction" is defined in subsection 245(1) to include an arrangement or event.

9 Defined in subsection 245(3), and discussed below.

10 Subsection 245(4) makes it clear that GAAR will also apply to an avoidance transaction that results in a misuse or abuse of the provisions of the Income Tax Regulations, the Income Tax Application Rules, a tax treaty, or any other enactment that is relevant in computing tax or some other amount payable or refundable under the Act.

of a tax benefit has therefore been regarded as not particularly high.[11] In the vast majority of cases, courts have simply identified a comparable transaction in which the taxpayer would have paid more tax, and have concluded that a benefit exists on that basis. In other, less common circumstances, courts have imposed a more stringent test by requiring that the comparable transaction be one that the taxpayer would, but for tax reasons, actually pursue.[12] In all such cases, however, the comparable transaction must be one that "might reasonably have been carried out but for the existence of the tax benefit."[13]

Avoidance Transaction

In general terms, an avoidance transaction is defined as any transaction that gives rise to a tax benefit, unless it was undertaken or arranged primarily for bona fide purposes other than to obtain a tax benefit.[14] It follows that if a transaction is not primarily tax-motivated (for example, the transaction is undertaken principally for economic, investment, commercial, or estate-planning reasons), it cannot be characterized as an avoidance transaction.

If, on the other hand, the primary purpose of one transaction within a series is to obtain a tax benefit, it will constitute an avoidance transaction,[15] even if every other transaction within the same series is undertaken for bona fide non-tax purposes. It is important to note, however, that a transaction will not be an avoidance transaction merely because an alternative transaction that might have achieved an equivalent non-tax result would have resulted in more taxes.[16]

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11 *Canada Trustco Mortgage Company v. The Queen*, 2003 TCC 215, at paragraph 55.

12 A transaction will not be regarded as comparable if it is "theoretically possible but, practically speaking, unlikely in the circumstances": *Canadian Pacific Ltd. v. The Queen*, 2000 CanLII 265, at paragraph 12 (TCC).

13 *Copthorne Holdings*, supra note 2, at paragraph 35, quoting David G. Duff, Benjamin Alarie, Kim Brooks, and Lisa Philipps, *Canadian Income Tax Law*, 3d ed. (Markham, ON: LexisNexis Butterworths, 2009), at 187.

14 Under the reporting regime contained in section 237.3, taxpayers are required to assist tax administrators by identifying avoidance transactions with certain hallmarks.

15 *Canada v. MacKay*, 2008 FCA 105, at paragraph 21.

16 *Copthorne Holding Ltd. v. Canada*, 2009 FCA 163, at paragraphs 54-55; and *Spruce Credit Union v. The Queen*, 2012 TCC 357, at paragraph 69, currently under appeal. See also the explanatory notes to section 245, which state, "Subsection 245(3) does not permit the 'recharacterization' of a transaction for the purposes of determining whether or not it is an avoidance transaction. In other words, it does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes." Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Department of Finance, June 1988), at clause 186. This passage was quoted with approval by the Supreme Court in *Canada Trustco*, supra note 4, at paragraph 30.

Misuse or Abuse

Given the low threshold for establishing the existence of a tax benefit and avoidance transaction, the focus in most GAAR cases is on determining whether the transaction results in a misuse or abuse of particular provisions or of the Act read as a whole. The so-called misuse or abuse test is often regarded as the single most important limitation on GAAR since the minister (of national revenue) must demonstrate that the overall impact of the transaction or series is clearly abusive within the scheme of the Act, notwithstanding that each of its elements is otherwise unimpeachable.[17]

The concept of abusive tax avoidance, when considered in the abstract, appears relatively straightforward. Unless the avoidance transaction in question clearly frustrates the purpose of the provisions conferring the tax benefit, it should not be regarded as abusive under GAAR. Construing the provisions of the Act, however, is an inherently flexible exercise in statutory interpretation. It requires the minister, and in turn a court, to discern legislative intent and give effect to policy choices embedded in legislation.

When the minister invokes GAAR, the minister effectively concedes that the words of the Act are inadequate to address the perceived misuse or abuse.[18] More particularly, the minister seeks to deny a tax benefit, not by reference only to the text of the relevant provisions, but with regard to some underlying policy of the Act that appears to have been frustrated.[19]

To deny a tax benefit where there has otherwise been strict compliance with the provisions of the Act requires that the relevant "context" and "purpose" of those provisions be detectable and detected—in other words, that their underlying rationale or policy be clear and unambiguous.[20] As simple as this threshold may seem at first blush, the reality is that perceptions of policy often differ. What may be clear to the minister may not be so clear to a court, and what appears clear to the court may be far from clear when viewed by the taxpayer. But there is more to the misuse and abuse analysis than perception.

17 It is rare, though not impossible, for a court to conclude the GAAR does not apply to an "arguably abusive" transaction because the taxpayer has succeeded in demonstrating that there was no avoidance transaction. See, for example, *Spruce Credit Union*, supra note 16, at paragraph 109, per Boyle J: "The requirements of the GAAR require there to be an avoidance transaction, regardless of an arguably abusive result."

18 *Copthorne Holdings*, supra note 2, at paragraph 109.

19 To demonstrate that there has been a misuse or an abuse under the Act, the minister must be able to identify a statutory scheme to establish the underlying policy of the relevant provisions and may do so by reference to extrinsic evidence (for example, statements from the Department of Finance or Parliament coincident with the issuance of draft legislation). In defending against a GAAR assessment, the Crown must disclose in its pleading the "policy" (that is, the object, spirit, and purpose) underlying the relevant provisions relied upon by the minister in raising the assessment. See *Birchcliff Energy Ltd. v. Canada*, [2013] 3 CTC 2169 (TCC).

20 *Canada Trustco*, supra note 4, at paragraph 41.

Words have meanings that are informed by the context in which they are used and, accordingly, may have different meanings in different contexts. There is a difference, however, between discerning the meaning of a provision and defining its underlying policy. In the latter situation, the text of a provision may be clear but its underlying rationale may not be captured by the bare meaning of the provision itself. As arcane as the GAAR analysis may therefore appear when examined in isolation, its application fundamentally hinges on purposive interpretation. Courts are obliged in applying GAAR to ground their perceptions of policy in the relevant provisions of the Act through a "process of reasoned elaboration."[21]

Whatever else may be said of the misuse or abuse analysis, it is critical to appreciate that this analysis is almost entirely fact-driven.[22] It comes as little surprise in reviewing the jurisprudence that the most egregious of cases have involved arrangements that were concocted, circular, unduly complex, or devoid of commercial purpose, or that tended to disclose a "degree of artificiality, boldness, vacuity or audacity."[23] Tax purists may insist that, in deciding these cases, the courts were unaffected by the facts, no matter how offensive the arrangement in question or how controversial its impact. But it would be naïve not to recognize that judicial outcomes in the GAAR context have varied far more with the facts than with the judges who rendered these decisions.

FISCAL MORALITY: THE IMPACT OF INSTINCT

Courts have the power to make interpretive choices, and are called upon to exercise it, when deciding GAAR cases. Choice in this context is both endemic and integral to the decision-making process. This power represents much more than judicial creativity or innovation. It is, in essence, the process by which a court translates the requirements of the Act into legal principles or the basis for those principles and, once the facts of the case have been determined, ultimately arrives at its decision.

Neither fairness nor fiscal morality tend to be given as reasons for the choices made by the courts. Judges may say, for example, that they do not accept a particular proposition to be correct in law because to do otherwise would be absurd or unrealistic, but they do not openly reject it on the basis that it is unfair or immoral. Having reasoned through the issues, a judge may at times add a comment to the effect that the decision has the advantage of coinciding with the merits or has the impact of doing justice as between the parties. But judges, including those who admit to the existence of fiscal morality as a factor in the analysis, rarely admit that they have

21 Henry M. Hart Jr. and Albert M. Sacks, *The Legal Process: Basic Problems in the Making and Application of Law* (Cambridge, MA: Harvard University Press, 1958), at 162-68.

22 *Mathew v. Canada*, 2005 SCC 55, at paragraph 59.

23 *Collins & Aikman Products Co. v. The Queen*, 2009 TCC 299, at paragraph 109. See also *McNichol et al. v. The Queen*, 97 DTC 111 (TCC), and *RMM Canadian Enterprises Inc. et al. v. The Queen*, 97 DTC 302, at 312 (TCC), per Bowman J (as he then was): "It is easier to recognize an abuse or a misuse than to formulate a definition that fits all circumstances."

reached a certain decision because it is morally appealing. Morality, it seems, is a more subtle agent in the interpretation of GAAR and its application.

The suggestion that morality might have some undefined part to play in the GAAR analysis is hardly novel and certainly not groundbreaking. It has long coexisted, either implicitly or explicitly, with GAAR itself.[24] In more recent times, however, the concept has received public attention.[25] It has become increasingly fashionable to use terms such as "aggressive" or "unacceptable" tax avoidance and to intimate that such practices demonstrate a lack of morality in tax matters.

While it is all too easy to suggest that, in deciding a GAAR case, a court might be influenced by its own sense of morality, there is no statutory basis for applying a moral standard in determining the outcome of a tax dispute. Taxpayers are, of course, obligated to pay taxes to finance public goods and services, but morality has very little to do with this, particularly since there is no general agreement as to the meaning of morality or its role in this context:

> In quantifying a taxpayer's tax liability under the *Income Tax Act* . . . is it ever necessary to evaluate the morality of the taxpayer's conduct? As a matter of general principle, the answer should be no. The *Income Tax Act* is intended to raise revenue for the use of the federal government. It also contains provisions intended to facilitate the distribution of social benefits according to standards established by Parliament, or to encourage or discourage certain industries or commercial practices in the public interest as perceived by Parliament from time to time. But nothing in the *Income Tax Act* expressly permits or requires the Minister of National Revenue, or the Courts, to apply the *Income Tax Act* differently depending upon the morality of the taxpayer's conduct.[26]

The legitimacy of avoiding tax, at least as a matter of principle, can be traced to a series of cases that are epitomized by the *Duke of Westminster*.[27] In that case, the

24 It has been suggested that notions of fiscal morality are inherent in the words "misuse and abuse." See Sheldon Silver, "Ethical Considerations in Giving Tax Opinions," in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 36:1-16, at 36:15: "What does appear to be clear, however, is that GAAR does raise or revive certain ethical considerations. There is a concept of morality inherent in the words 'misuse' and 'abuse,' and it remains to be seen whether these words raise new ethical considerations and will encourage practitioners to apply a 'smell' test." But see also *Copthorne Holdings*, supra note 2, at paragraph 65, where the Supreme Court explicitly states otherwise.

25 In connection with a report released by the UK Public Accounts Committee on December 3, 2012, committee chair Margaret Hodge stated, "We consider that paying an appropriate amount of tax in the country in which profits are made is not only a matter of basic economics. It is also a matter of morality." See United Kingdom, Public Accounts Committee, "Committee Publishes Findings on HMRC's Accounts 2011-12," December 3, 2012 (www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/news/hmrc-accounts-2011-12-report).

26 *Canadian Imperial Bank of Commerce v. Canada*, 2013 FCA 122, at paragraph 1, per Sharlow JA.

27 *Commissioners of Inland Revenue v. Westminster (Duke)*, [1936] AC 1 (HL) (herein cited as *Duke of Westminster*).

House of Lords declared that "[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be."[28] The House of Lords was similarly explicit on this point in another leading case, stating that no man "is under the smallest obligation, moral or other, so to arrange his legal relations . . . as to enable the Inland Revenue to put the largest shovel into his stores."[29]

Canadian courts have generally kept pace with their English counterparts in recognizing that tax may permissibly be avoided and that this is not "tax avoidance" in the pejorative sense.[30] The Supreme Court has repeatedly stated that "taxpayers are entitled to arrange their affairs to minimize the amount of tax payable,"[31] and has consistently rejected the absence of economic substance or business purpose as a basis for finding abusive tax avoidance.[32] Perhaps for this reason, taxpayers, in structuring their affairs, have paid little attention to what a court might consider to be the (morally) correct course of action.

The concept of fiscal morality, particularly in the GAAR context, is not an absolute. Under any conception of GAAR, however, there are arrangements that even the most aggressive taxpayer would recognize as too good to be true.[33] Although GAAR was never intended to be a barometer for morally acceptable conduct, tax administrators are generally disinclined to endorse arrangements that result in the fisc being unduly deprived of its due. Court dockets are thus replete with cases where taxpayers have failed to properly execute "an ingenious strategy devised by clever tax practitioners,"[34]

28 Ibid., at 19, per Lord Tomlin. But see *Furniss v. Dawson*, [1984] STC 153, at 157 (HL): "[T]he ghost of the *Westminster* case and of [the Duke's] transaction, be it noted a single and not a composite transaction, with his gardener and with other members of his staff, has haunted the administration of this branch of the law for too long. I confess that I had hoped that that ghost might have found quietude. . . . Unhappily it has not. Perhaps the decision of this House in these appeals will now suffice as exorcism."

29 *Ayrshire Pullman Motor Services and D.M. Ritchie v. The Commissioners of Inland Revenue* (1929), 14 TC 754, at 763 (Scot. Ct. Sess.).

30 *Jabs Construction Ltd. v. The Queen*, 1999 CanLII 520, at paragraph 48 (TCC), per Bowman J (as he then was): "Section 245 is an extreme sanction. It 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." This passage was cited with approval by Binnie J in *Lipson*, supra note 2, at paragraph 62.

31 *Canada Trustco*, supra note 4, at paragraph 11. See also *Lipson*, supra note 2, at paragraph 54; and *Copthorne Holdings*, supra note 2, at paragraph 65.

32 *Canada Trustco*, supra note 4, at paragraphs 14 and 57. See also *Lipson*, supra note 2, at paragraph 38; *Stubart Investments Ltd. v. The Queen*, [1984] 1 SCR 536, at 575; and *Continental Bank Leasing Corp. v. Canada*, [1998] 2 SCR 298, at paragraph 51.

33 *Campbell v. Commissioners of Inland Revenue* (1968), 45 TC 427, at 448 (CA), per Harman LJ: "It is a splendid scheme. . . . It is almost too good to be true. In law quite too good to be true. It won't do."

34 *Antle v. The Queen*, 2009 TCC 465, at paragraph 38.

or have executed a series of transactions that, although not abusive when viewed in isolation, somehow still frustrated a specific policy within the Act.[35]

In reviewing these cases, the question necessarily arises: Why is it that, 25 years after its enactment, and after approximately 50 appeals, GAAR still harbours uncertainty? To what extent in these decisions are notions of fiscal morality—implied by the courts and embraced by those affected by the decisions—really to blame? Alternatively, if each of the cases can be justified on a principled basis, what role (if any) does morality have to play?

In an ideal world, morality would serve no such role. A nebulous concept of this kind can hardly assist in navigating the already complex and uneven terrain of the Act. If anything, it can only serve to compound the uncertainties that are now characteristic of GAAR and its scope. That said, one can readily acknowledge the fact that the law is not an end in itself. It exists to do justice and therefore cannot be divorced from the courts' perception of what is fair or appropriate. As the distinguished American appellate court judge, Richard A. Posner, has observed, "judges are not moral or intellectual giants (alas), prophets, oracles, mouthpieces, or calculating machines."[36] Many of their difficult decisions are influenced by *other* internal aspects, such as personality, policy intuitions, and professional and life experiences.[37]

These personal factors, whether consciously or not, play an important role in GAAR cases. In fact, it would be impossible for tax administrators, as well as the courts, to approach the task of applying GAAR without being affected by their own impressions of those who operate at the edge of the envelope. This is not to suggest that, in resolving GAAR disputes, visceral reactions should dictate the analysis, but merely to acknowledge that the law is not analyzed in a moral vacuum:

> I think that there is a strong subjective element in GAAR. But I also think that GAAR is essentially a very complex codification of what some might refer to as a judicial sense of when a situation is within the reasonable contemplation of the law, and has been properly implemented, and when it isn't and hasn't. Some might refer to this as a "smell test." I suppose it might look that way, and sometimes the reasons for a decision might not reflect the full step-by-step thinking leading to an outcome. But judges have

35 *Lipson*, supra note 2, at paragraph 48. See also *Copthorne Holdings Ltd. v. The Queen*, 2007 TCC 481, at paragraph 25, per Campbell J: "The transactions in this appeal are numerous and at first glance lengthy and complex. If one looks at these transactions in conjunction with the governing provisions contained in the Act, it is not immediately apparent why any of the corporate undertakings should have attracted the application of GAAR. However, as the saying goes 'that would not be seeing the forest for the trees [sic].' When I step back and look at the big picture of what occurred here, the [transactions] resulted in [abusive tax avoidance]."

36 Richard A. Posner, *How Judges Think* (Cambridge, MA: Harvard University Press, 2008), at 7. See also Hon. John I. Laskin, "What Persuades (or, What's Going on Inside the Judge's Mind)" (2004) 23:1 *Advocates' Society Journal* 4-9, at 7: "Many unseen forces guide our thoughts and actions—our likes and dislikes, our moods, instincts, emotions, habits, and convictions."

37 Posner, supra note 36, at 11 and 369-70.

> a sense that is informed by their experience with the law, within the framework that counsel set out to argue a case, and just because the reasons for a decision might appear results-based doesn't mean that they are. By the same token, human nature plays a role in everything, and inevitably there will be cases that provoke one or another kind of initial reaction—though good judges get beyond that in their application of the law, with the benefit of their experience.[38]

Recent GAAR decisions are a testament to the fact that the appetite for tax gamesmanship is much reduced.[39] Although it is difficult to attribute the change in temperament to any one cause, there is no denying that tax avoidance is no longer the competitive sport it once was. Be it the fallout of the financial scandals that are now synonymous with corporate powerhouses such as Enron, or the aftermath of the global economic crisis, the current era has been defined by deficits and general decline. In the wake of these events, it is possible that the courts, being a reflection of society, have been less than eager to condone aggressive measures.

The public profile of tax has also changed dramatically in recent years. Previously tax had very little connection to corporate governance and reputational risk. The mandate of the tax director was to ensure that compliance obligations were fulfilled, tax positions were disclosed for accounting purposes, and sufficient legal and financial support was provided for estimates. Today tax is on the radar screens of executive officers, shareholders, and other interested stakeholders, including governments, regulators, and the public.

Corporate taxpayers are less inclined in current times to engage in tax planning that might be construed as "unacceptable" simply because they do not want to be labelled as "high risk" by the tax authorities or targeted by the press as engaging in unethical tax behaviour. Given, however, that tax planning can be considered by some to be acceptable in certain situations and by others to be unacceptable in similar circumstances, the concept of "acceptable" tax avoidance, by its own terms, raises the ultimate question, "Acceptable to whom?"[40]

There is no easy answer to this question, and there may never be. But once we accept, as logic dictates we must, that judges face a multiplicity of choices in deciding cases, the focus rightly shifts away from the perspectives of particular judges and centres on the process by which such choices are exercised. It has already been

38 Hon. Donald G.H. Bowman with Al Meghji and J. Scott Wilkie, "A Fireside Chat with the Chief Justice of the Tax Court of Canada" (2010) 58, special supp. *Canadian Tax Journal* 29-40, at 34.

39 See, for example, *Antle*, supra note 34 (aff'd. 2010 FCA 280; application for leave to appeal to the Supreme Court of Canada dismissed).

40 To echo the sentiments of the House of Lords, "[t]he fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether [an anti-avoidance rule] applies or not." See *MacNiven v. Westmoreland Investments Limited*, [2001] UKHL 6, at paragraph 62.

noted that a close examination of the facts is essential to this process. Some judges will instinctively seek to fit the facts within the law and assume, or hope, that justice has been achieved in the abstract. Others will first find the facts and then adapt the law accordingly so as to do justice in the circumstances. In either scenario, the sense of fair play that most judges seek to achieve can be assured only if they come to the task of deciding GAAR cases with a certain amount of discretion, and exercise an equal amount of discipline in conducting the requisite analysis.

Likewise, the task for practitioners in advising clients, and for the tax authorities in raising assessments, is to remain cognizant that the application of GAAR is inherently a legal issue.[41] To imply that there is an element to this analysis that hinges on whether the taxpayer is getting away with something places far less faith than is required in both the integrity of GAAR and the courts' ability to administer this rule.[42]

STATUTORY INTERPRETATION: THE REQUIREMENT OF RIGOUR

In determining whether the provisions of the Act have been misused or abused in particular circumstances, the reviewing court necessarily engages in statutory interpretation. Accordingly, any reasoned examination of GAAR compels a critical review of the courts' approach to interpreting the Act.

The Act was historically subject to the strict or literal approach to statutory interpretation. Recognizing the Act to be a highly detailed, meticulously drafted, and integrated piece of legislation, courts placed greater emphasis on the text of various provisions as opposed to their context or purpose. This conservative approach to interpreting the Act facilitated efforts to defend tax-avoidance schemes and provided the requisite certainty in planning them.

The purposive approach was first clearly endorsed by the Supreme Court in *Stubart*.[43] In that case, Estey J, writing for a unanimous court, considered the rule of strict construction as it had historically applied to taxing statutes, but then referred to the Act, stating it was "no longer a simple device to raise revenue."[44]

41 G.S.A. Wheatcroft, "The Attitude of the Legislature and the Courts to Tax Avoidance" (1955) 18:3 *Modern Law Review* 209-30, at 218: "[W]hatever may be the personal sympathies of a judge who tries a revenue case, his decision has to be based on purely legal and technical grounds." See also Alan M. Schwartz and Kevin H. Yip, "Policy Forum: Defending Against a GAAR Reassessment" (2014) 62:1 *Canadian Tax Journal* 129-46.

42 *Pezzelato v. The Queen*, 96 DTC 1285, at 1290 (TCC), per Bowman J (as he then was): "Visceral reaction, however much it may form the inarticulate premise upon which judicial decisions are sometimes founded, is not . . . a substitute for legal analysis." See also *ACM Partnership v. Commissioner*, 157 F. 3d 231, at 265 (3d Cir. 1998), per McKee Circuit Judge (in dissent): "The fact that [the taxpayer] may have 'put one over' [on the tax authority] in crafting these transactions ought not to influence our inquiry. Our inquiry is cerebral, not visceral."

43 *Stubart*, supra note 32, at 575.

44 Ibid.

Under the traditional rule, interpretive ambiguities in charging provisions would generally be resolved in favour of the taxpayer, and the opposite was true for exempting provisions. However, the court in *Stubart* dispensed with this rule and concluded that it would be appropriate in future cases to adopt a purposive approach in interpreting statutory provisions.[45]

The interpretive guidelines established in *Stubart* were poised to place substantial limits on the ability of taxpayers to engage in abusive tax avoidance. However, those limits never came into being. Parliament introduced GAAR, which it viewed as a more robust mechanism. It may be that the government chose to react legislatively just at the time that the Supreme Court had offered tax administrators the necessary interpretive tools to effectively deal with abusive practices; however, those tools were likely not regarded as effective enough.[46]

The purposive approach resurfaced, this time in full force, when the Supreme Court rendered its decision in *Canada Trustco* two decades after *Stubart*. In *Canada Trustco*, McLachlin CJ and Major J confirmed for a unanimous court that where the text of the Act was precise and unequivocal, the ordinary meaning of words would play a dominant role in interpreting its provisions. However, the court also observed that, even where the ordinary meaning of a provision did not appear to be ambiguous at first glance, statutory context and purpose could reveal latent ambiguities. To resolve such ambiguities, the court stated, courts would be required to undertake "a unified textual, contextual and purposive approach to statutory interpretation."[47]

Decisions of the Supreme Court subsequent to *Canada Trustco*, including, most recently, *Copthorne Holdings*, have consistently affirmed the principles of construction expressed in that case.[48] In fact, if these decisions are any indication, it is no longer sufficient (if it ever was) for a taxpayer to demonstrate that it has complied with the text of the Act, particularly where the transaction in issue appears to be inconsistent with the legislative rationale underlying the relevant provisions.[49]

The textual, contextual, and purposive approach, of course, continues to demand that judges scrupulously review the text to determine whether it sheds light on what the provisions were intended to achieve (versus what they might appear to permit),

45 Ibid., at 575-76.

46 Judith Freedman, "Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance" (2005) 53:4 *Canadian Tax Journal* 1038-46, at 1043-44.

47 *Canada Trustco*, supra note 4, at paragraph 47.

48 See *Placer Dome Canada Ltd.*, supra note 4, at paragraphs 21-23; and *Imperial Oil Ltd. v. Canada; Inco Ltd. v. Canada*, 2006 SCC 46, at paragraphs 27-29.

49 The modern approach to GAAR was foreshadowed by the decision in *OSFC Holdings Ltd. v. Canada*, 2001 FCA 260. See, for instance, ibid., at paragraph 65, per Rothstein J: "I do not lightly distinguish the pointed statements of the Supreme Court of Canada in cases such as *Shell* . . . and *Antosko* . . . that where the words of the *Income Tax Act* are clear they must be applied. However, in none of the cases in which the Supreme Court has set out this view did the Minister invoke section 245 as it now reads. . . . [T]hese statements of the Supreme Court cannot be said to apply to a misuse and abuse analysis under subsection 245(4)."

and to be cautious when straying from the clear meaning of words.[50] However, this approach requires judges to read the Act in a way that provides the most coherent interpretation of the legislative process as a whole. What it also requires is that this examination be openly articulated. The fact that it must be an open process disciplines the exercise of judicial power.

Where GAAR is concerned, it is simplistic to assume that any one judicial approach will yield dispositive solutions to controversial issues of interpretation. The application of GAAR is much too debatable for that. While it is therefore easy to suggest that courts should adopt a conservative stance in relation to GAAR and, when faced with ambiguities, defer to Parliament, any such suggestion (well intended as it may be) fundamentally mistakes the nature of the judicial function in the GAAR context:

> A statute may indicate or require as its justification a change in the policy of the law, although it expresses that change only in the specific cases most likely to occur to the mind. The Legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before.[51]

The only way in which Parliament can express its intention to impose income tax is through the Act. If Parliament has so intended to impose tax, courts should be trusted in interpreting the Act to discern that intention.[52] Surely, when confronted with abusive conduct, courts are not at liberty to assert principles that are not explicit in the Act or necessarily implied. Nor are they permitted to divine any overarching policy that supersedes the limits of specific provisions. But, aside from these caveats, there is no reason why, in defining the scope of GAAR, courts should refrain from construing the provisions of the Act in a reasoned manner, drawing upon accepted principles of interpretation and, indeed, upon common sense.[53]

To the contrary, it is incumbent upon the judiciary in such cases, as it is in the tax context generally, to exercise judgment in making the statute coherent.[54] This is not

50 *Canada Trustco*, supra note 4, at paragraph 11. See also *Copthorne Holdings*, supra note 2, at paragraph 88; and *Toronto-Dominion Bank v. Canada*, 2011 FCA 221, at paragraph 61.

51 *Johnson v. United States*, 163 F 30, at 32 (1st Cir. 1908).

52 Leonard Hoffmann, "Tax Avoidance" [2005] no. 2 *British Tax Review* 197-206, at 203.

53 *United States v. Standard Oil Co.*, 384 US 224, at 225 (1965): "[W]hatever may be said of the rule of strict construction, it cannot provide a substitute for common sense, precedent, and legislative history." See also *United States v. Brown*, 333 US 18, at 25 (1948): "The canon in favor of strict construction is not an inexorable command to override common sense and evident statutory purpose."

54 Ronald Dworkin, *Law's Empire* (Cambridge, MA: Belknap Press, 1986), at 313-14.

merely because a court can do so, or because its opinion is automatically right, but because no court can properly answer any question of statutory construction without relying at the deepest level on what it believes to be the most appropriate reflection of legislative intent.[55] Stated differently, a court is permitted, in choosing one interpretation over another, to develop a working conception of the law, provided that it does so in the right direction:

> The judge should try to think his way as best he can into the minds of the enacting legislators and imagine how they would have wanted the statute [to be] applied to the case at bar.
>
> Now it is easy to ridicule this approach by saying that judges do not have the requisite imagination and that what they will do in practice is assume that the legislators were people just like themselves, so that statutory construction will consist of the judge's voting his own preferences and ascribing them to the statute's draftsmen. But the irresponsible judge will twist any approach to yield the outcomes that he desires and the stupid judge will do the same thing unconsciously.[56]

If courts fail to exercise a responsible role in assuring the integrity of the Act, the notion of permissible tax avoidance is reduced to nothing more than a game, in which the well advised win and the rest pay taxes.[57] To suggest, therefore, that courts should leave it entirely to Parliament is to minimize their function in the GAAR context. It may be that a court, in construing GAAR, should apply the Act as the court finds it, and it may also be true that there are no uniquely right answers in GAAR cases. In either event, it would be a disservice to Parliament, the tax authorities, and taxpayers in general if courts did not labour to decide such cases on a principled basis.

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55 Brian J. Arnold, "Policy Forum: Some Thoughts on the Supreme Court's Approach to the Determination of Abuse Under the General Anti-Avoidance Rule" (2014) 62:1 *Canadian Tax Journal* 113-27.

56 Richard A. Posner, "Statutory Interpretation—In the Classroom and in the Courtroom" (1983) 50:2 *University of Chicago Law Review* 800-22, at 817.

57 Robert Thorton Smith, "Interpreting the Internal Revenue Code: A Tax Jurisprudence" (1994) 72:9 *Taxes: The Tax Magazine* 527-58, at 555. See also *Latilla v. Commissioners of Inland Revenue* (1943), 25 TC 107, at 117 (HL), per Lord Simon: "Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are 'entitled' to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres."

THE ACTUAL GAAR ANALYSIS

It is often argued, and with good reason, that GAAR should be applied in a manner that affords taxpayers relative certainty in tax planning. Certainty depends, after all, upon the ability to plan, and taxpayers are entitled (at least in theory) to plan on the basis that like cases will be decided in like ways. There are, of course, a good many who believe that visceral influences are determinative in any GAAR analysis and that judicial attitudes toward tax avoidance have at least as much to do with judgments about fiscal morality as with what the law dictates. But the application of GAAR, despite belief to the contrary, remains a question of statutory construction in each case:

> 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. However, determining the rationale of the relevant provisions of the Act should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do.*[58]

Decisions based upon individual perceptions of policy (as they often are in the GAAR context) make decision making unpredictable, to say the least. What is required at a minimum, therefore, in construing the policies of the Act is an objective assessment of the law as opposed to an instinctive reaction to the facts. Perceptions of equity or fairness may affect the decision-making process, but such influences neither require nor justify a departure from the rigour that the GAAR analysis demands.

Through the lens of rigour, the vast majority of GAAR disputes can be seen to raise similar legal considerations, despite the differing factual circumstances in which they arise. These considerations provide a framework within which such cases can, and should, be analyzed. What follows is an examination of the more significant considerations that inform the application of GAAR.

Identifying the Real Transaction

The first, and most critical, consideration in the GAAR analysis is whether the transaction resulting in the contested tax benefit has been correctly characterized. The

58 *Copthorne Holdings*, supra note 2, at paragraph 70, per Rothstein J (emphasis added). See also 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 4:4, where Justice Rothstein observed, "GAAR has an overriding effect. Whenever judges are faced with a general overriding provision, they will be cautious. When we look at the detailed structure of the Act, we want to be very careful, when it comes to applying the general overriding provision, that we are correct. . . . *As judges, we have to always keep in mind that it is Parliament—not the minister, and certainly not the courts—that imposes income tax, so we will want to be careful not to impose our subjective judgment as judges as to what constitutes a misuse or an abuse* [emphasis added]."

need for this inquiry is rooted in the definition of "avoidance transaction," which requires, as a preliminary step, that the transaction be identified.

It is well settled that, in identifying the transaction, legal relationships must be respected. Courts are accordingly obliged to first assess these relationships and then characterize them for tax purposes. Any such assessment requires a meticulous examination, not only of how the disputed arrangement was configured in formal terms, but also of what the reasonable expectations of the taxpayer were as to its significance. This is an inherently legal analysis, although it may depend in part on what is revealed by the evidence.[59]

If each of the steps in a transaction (or transactions in a series) has been properly documented, and the taxpayer intends to assume the consequences of its dealings in a manner that is consistent with their documented form, the transaction will be regarded as legally effective and generally not be disturbed, subject to the application of specific anti-avoidance provisions and GAAR. For the purposes of GAAR, the "transaction" can be understood as the legal rights and obligations that the parties have created for themselves, notwithstanding the terms that have been used to describe them:

> This leads logically to the next question: *did the appellants enter into the various transactions that they purported to, or was the elaborate series of steps . . . a mere camouflage for what was in substance a single event*. . . . In cases of this type expressions such as sham, cloak, alias, artificiality, incomplete transaction, simulacrum, unreasonableness, object and spirit, substance over form, *bona fide* business purpose, step transaction, tax avoidance scheme and, no doubt, other emotive and, in some cases, pejorative terms are bandied about with a certain abandon. *Whatever they may add, if anything, to a rational analysis of the problem*, apart from a touch of colour in an otherwise desiccated landscape, *they do not exist in separate watertight compartments*. They are all merely aspects of an attempt to articulate and to determine where "acceptable" tax planning stops and fiscal gimmickry starts.[60]

It is important to appreciate that, under Canadian law, the "transaction" is not an economic analogue of the legal transaction that the taxpayer purported to implement.[61] Nor does identifying the "transaction" require a court to reconstruct the transaction actually undertaken by the taxpayer and convert it into something that in law it was not.[62] It is *the* transaction that was implemented, with all of its legal and

59 J. Scott Wilkie and Heather Kerr, "Common Links Among Jurisdictions: Informing the GAAR Through Comparative Analysis," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 34:1-30, at 34:13 and 34:28.

60 *Continental Bank of Canada et al. v. The Queen*, 94 DTC 1858, at 1866-67 (TCC).

61 Wilkie and Kerr, supra note 59, at 34:8.

62 *Lipson*, supra note 2, at paragraph 87, per Binnie J (in dissent): "Moreover, it is not sufficient, in my view, for the Minister to offer a general 'overall' conclusory snapshot of the series of transactions without regard to the legal relationships thereby created."

economic characteristics. In other words, the focus is on the legal character of a transaction rather than the label given to it:[63]

> *So here the substance is that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles.* . . . There may, of course, be cases where documents are not *bona fide* nor intended to be acted upon, but are only used as a cloak to conceal a different transaction. No such case is made or even suggested here.[64]

In interpreting the provisions of the Act, a court will be guided by prevailing canons of statutory construction. But in characterizing transactions there is little available in the way of guidance, except for experience and common sense. In Canada, the debate in relation to characterization has always focused on form versus substance: that is, whether, and to what extent, a court should be bound by the form in which a transaction has been cast, or whether the court may look instead to some economic equivalent—a variant on the one actually implemented—and attach the appropriate tax consequences to that variant. The real challenge, however, lies in notionally setting aside the concept of series (or the perception that each step in a chain of circumstances is a transaction) and actually examining the entire arrangement, with each of its legally enforceable elements.[65] This was acknowledged by the Supreme Court, most recently in *Copthorne Holdings*, when it stated:

> While the focus must be on the transaction, where it is part of a series, it must be viewed in the context of the series to enable the court to determine whether abusive tax avoidance has occurred. In such a case, whether a transaction is abusive will only become apparent when it is considered in the context of the series of which it is a part and the overall result that is achieved.[66]

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63 *Ben Nevis Forestry Ventures Ltd v. CIR*, [2008] NZSC 115, at paragraph 48. See also *Evans v. The Queen*, 2005 TCC 684, at paragraph 35.

64 *Duke of Westminster*, supra note 27, at 20-21 (emphasis added). See also *Commr. of Inc.-Tax v. B.M. Kharwar* (1968), 72 ITR 603, at 607 (India SC): "The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by a device the legal relation, it is open to the taxing authorities to unravel the device and to determine the true character of relationship. But the legal effect of a transaction cannot be displaced by probing into the 'substance of the transaction.' "

65 Under the common-law definition of the concept, a series involves a number of preordained transactions that are intended to produce a given result, with "no practical likelihood that the subsequent transaction or transactions will not take place": see *OSFC Holdings*, supra note 49, at paragraph 24, per Rothstein J. Subsection 248(10) expands this definition by deeming any related transaction to be a part of the series if it is completed "in contemplation of" that series. See *Canada Trustco*, supra note 4, at paragraph 26. In applying the expanded definition, a court is only required to consider whether the series was taken into account when the decision was made to undertake the related transaction, in the sense that the transaction was undertaken "in relation to" or "because of" the series. The "because of" or "in relation to" test requires more than a "mere possibility" or a connection with "an extreme degree of remoteness": *MIL (Investments) SA v. The Queen*, 2006 TCC 460, at paragraph 62.

66 *Copthorne Holdings*, supra note 2, at paragraph 71.

Provided that the transaction reflects the legal rights and obligations created by the taxpayer, the Act generally applies as anticipated. Otherwise, the Act must be applied to the transaction on the basis of its legal character, and this may be inferred from the manner in which the taxpayer conducted itself. To be clear, as others have said, GAAR does not permit the minister (or a court) to tell the taxpayer:

> You used one legal structure but you achieved the same economic result as that which you would have had if you used a different one. Therefore I shall ignore the structure you used and treat you as if you had used the other one.[67]

Recognizing the Significance of Substance

The second most significant consideration in the GAAR analysis relates to the role of commercial or economic substance.[68] Although not cast in such terms, GAAR seems to have imported this concept into the Act by requiring in the definition of "avoidance transaction" that the particular transaction may reasonably be considered to have been undertaken primarily for a non-tax purpose:

> [W]here a transaction takes place primarily for a non-tax purpose, there will be no avoidance transaction. In the absence of an avoidance transaction, the fact that a transaction may have a secondary tax benefit purpose will not trigger the GAAR. . . .
>
> 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.[69]

The use of the words "may reasonably be considered" indicates that the test is an objective one and that subjective intent or motive is largely immaterial.[70] A transaction

67 *Continental Bank*, supra note 60, at 1871. See also *Shell Canada Ltd. v. Canada*, [1999] 3 SCR 622, at paragraph 45: "[A] taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done"; and Wilkie and Kerr, supra note 59, at 34:5-6.

68 For a detailed review of the economic substance doctrine, see Jinyan Li, "'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) 54:1 *Canadian Tax Journal* 23-56.

69 *Copthorne Holdings*, supra note 2, at paragraphs 120-121.

70 *OSFC Holdings*, supra note 49, at paragraph 46, per Rothstein J: "The words 'may reasonably be considered to have been undertaken or arranged' in subsection 245(3) indicate that the primary purpose test is an objective one. Therefore the focus will be on the relevant facts and circumstances and not on statements of intention." See also *Copthorne Holdings*, supra note 2, at paragraph 59; and *Canadian Pacific*, supra note 12, at paragraph 15, per Bonner J: "It should be noted that the words 'may reasonably be considered' imply that the . . . purpose test is objective in nature. That is understandable having regard to the slippery and unreliable quality of statements of subjective intent as a basis for arriving at tax results."

is not "abusive" because it lacks an economic or commercial purpose. However, the case law establishes that motivation and economic substance *are* of consequence in considering whether the transaction has frustrated the purpose of the relevant statutory provisions.[71] In other words, a purposive analysis of the disputed provisions may dictate that a particular tax benefit is available only in respect of transactions with a certain economic, commercial, family, or other non-tax purpose. The absence of such considerations may then militate toward a finding that the transaction was devoid of substance.

In considering the application of GAAR, courts are required to consider the surrounding commercial and economic realities in which taxpayers have utilized specific provisions. Thus, the question is whether the transaction, viewed in the context of such realities,[72] relies on specific provisions in a manner that is consistent with their purpose:

> That is not to say that purpose is to be equated with the motive of the taxpayer or the motives of the architects of the arrangement. It is well established that motive is not determinative, although it may be evidence which sheds light on a purpose of tax avoidance and so is not wholly irrelevant.
>
> Tax avoidance occurs when the object or end in view or design of an arrangement is alteration of the incidence of tax and that object is not incidental to a business purpose. *Such assessment does not entail reconstruction of the arrangements entered into. It requires realistic assessment of their purpose or effect.*[73]

Since the provisions of the Act are intended to apply to transactions with real economic substance,[74] abusive tax avoidance may be found where a transaction lacks substance relative to the policy of the provisions that confer the tax benefit, or where the transaction achieves an outcome that is wholly dissimilar to what is contemplated by those provisions.[75]

71 *Canada Trustco*, supra note 4, at paragraph 57; and *Lipson*, supra note 2, at paragraph 38.

72 See, for example, *Canada v. Global Equity Fund Ltd.*, 2012 FCA 272, at paragraphs 67-68, per Mainville JA: "The Tax Court judge found that the transactions at issue in this case were 'vacuous' and 'highly artificial.' I agree. Like the proverbial rabbit out of the magician's hat, the loss which occurred as a result of these transactions was pulled out of thin air. These transactions are nothing more than a paper shuffle carried out with the purpose of creating an artificial business loss for the purpose of avoiding the payment of taxes otherwise owed on the profits resulting from the real-world business operations of [the taxpayer]. *There is no air of economic or business reality associated with the loss* [emphasis added]." See also *Triad Gestco Ltd. v. Canada*, 2012 FCA 258, and *1207192 Ontario Limited v. Canada*, 2012 FCA 259.

73 *Ben Nevis*, supra note 63, at paragraphs 8-9 (emphasis added).

74 *Explanatory Notes*, supra note 16, at clause 186.

75 *Canada Trustco*, supra note 4, at paragraphs 56-60.

The GAAR analysis hinges in this regard on determining whether the underlying expectations of the Act have been defeated, notwithstanding that the requirements of specific provisions have been satisfied. Granted that there is no one-size-fits-all approach to making this determination, what is clear is that commerciality and artificiality (among other criteria) can only go so far in satisfying the level of rigour required:

> Legal reality may often be trying to reflect some sort of commercial or economic reality but it will not achieve this in every case. This does not mean that the legal distinctions created are unreasonable and that taxpayers relying upon them are acting reprehensibly, since the entire system is based on legal distinctions and needs to be in order to operate. Sometimes this seems to operate in favour of the Revenue and sometimes the taxpayer, but since it is the foundation of the tax system, it cannot be eliminated. Artificiality alone cannot be said to be a hallmark of avoidance when so much about tax is artificial.[76]

Many bona fide commercial arrangements are highly complex and are significantly influenced by tax considerations. This does not, in and of itself, imply that such arrangements are offside. Any arrangement with tax consequences is in one sense artificial, in that the taxpayer may have structured its affairs differently had it not been for those consequences. However, many arrangements go further than this and are carried out in artificial ways to secure unintended tax results.[77] In all such cases, the applicability of GAAR lies in a rigorous analysis of the facts:

> How do I approach deciding a case? *First of all, I try to find out what the facts are. That's very important. At that point, I have probably reached a conclusion as to which way I am going to go.* Before I look at any law, I think, "What is the fair commonsense result?" and at that point I start looking around for the arguments that I need to achieve that result. Is this a fair reading of the statute? What jurisprudence do I have? So I look at judgments of other courts, and I try to find judgments that will support me—and believe me, the law is not consistent. You know, you can find for every proposition of law an opposite proposition.[78]

76 Judith Freedman, "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle" [2004] no. 4 *British Tax Review* 332-57, at 343.

77 In metaphorical terms, one might say, "[Y]ou can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it": Mark P. Gergen, "The Common Knowledge of Tax Abuse" (2001) 54:1 *SMU Law Review* 131-47, at 140.

78 Bowman, supra note 38, at 32.

The importance of the facts in the GAAR analysis cannot be overstated.[79] The facts inform every aspect of the inquiry.[80] Is there a tax benefit? Is there a series? Which transactions make up the series? Does the tax benefit result from the series? Is the primary purpose of each transaction in the series something other than to obtain that benefit? And, finally, does the avoidance transaction result in an abuse or misuse of the Act? Each of these questions requires that the transaction be viewed in its factual context, and if (but only if) it is considered to be abusive, that it be recharacterized to determine the reasonable tax consequences.

Minding Legislative Gaps

Once the facts have been determined, the analysis then proceeds to the interplay between GAAR and other specific provisions. A finding of abusive tax avoidance may ensue in circumstances where a taxpayer has relied on specific provisions to achieve an outcome that those provisions seek to prevent.[81]

In conducting this analysis, the court will generally start by examining the relevant provisions. If each provision is found to apply on its terms, that should be the end of the analysis. But life is seldom so simple. In many cases, the provisions in issue may not explicitly address, or even implicitly contemplate, the results that have been achieved in the particular situation.

In such cases, it is not the job of GAAR, any more than it is of the courts, to compensate for the failure of Parliament to express its purpose in enacting a provision. But where Parliament *has* clearly expressed its purpose, and specified precisely what conditions must be satisfied to achieve a particular result, a taxpayer is entitled to rely on those conditions to achieve the result that they prescribe.[82] In short, the minister cannot discharge the burden of establishing abusive tax avoidance by asserting

79 See Hon. Donald G.H. Bowman, Deen Olsen, Wayne Adams, Al Meghji, and Wilfrid Lefebvre, "GAAR: Its Evolution and Application," in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 2:1-23, at 2:15, where Meghji notes that the GAAR analysis "is very much a factual exercise, and that's why, out of the 15 cases that have gone to the Federal Court of Appeal, the court has upheld the Tax Court's analysis on misuse or abuse approximately 14 times; that is, in virtually all of the cases, the Federal Court of Appeal accepts the views of the Tax Court on what constitutes a misuse or abuse. And the reason that happens is because the trial judge is very influenced by the facts, by the story that comes out. This is in some respects a morality play, and most morality plays are resolved by reference to the facts. What's the story? The Tax Court judges are hugely influenced by the story, and they seem to rely on the facts in most instances. But judges, of course, come to the task with different experiences, different visions, and different ideas."

80 *Copthorne Holdings*, supra note 2, at paragraph 34.

81 *Canada Trustco*, supra note 4, at paragraph 45. See also *Lipson*, supra note 2, at paragraph 40; and *Copthorne Holdings*, supra note 2, at paragraph 72.

82 *Canada Trustco*, supra note 4, at paragraph 11. See also *Evans*, supra note 63, at paragraph 29.

that the taxpayer has managed to avoid the "shoals and traps" of the Act or has succeeded in exploiting a legislative gap.[83]

With respect to significance of subsequent amendments in relation to such loopholes, the courts have taken differing approaches over time. Under the current state of the law, however, such amendments are simply a relevant consideration in determining the policy of the particular provision.[84] Accordingly, the subsequent enactment of a specific anti-avoidance rule that may apply to defeat a tax-avoidance strategy challenged under GAAR does not in itself indicate that the strategy was abusive. Instead, the subsequent enactment must be considered along with all other relevant materials to ascertain the object, spirit, and purpose of the former provision.

In this context, it goes without saying that GAAR need not be invoked if a specific anti-avoidance provision applies. However, an abuse may result from an arrangement that circumvents (or has the effect of circumventing) the application of such provisions in a manner that frustrates their object, spirit, or purpose.[85] In other words, GAAR may apply where the underlying policy is clear from the scheme of relevant provisions, both ordinary and anti-avoidance, and where strict or literal compliance with those provisions nevertheless results in a misuse or abuse of that scheme.[86]

GAAR was found to apply in *Mathew*,[87] for instance, where the minister successfully established that there was an overriding policy in the Act against the transfer or sharing of losses between unrelated taxpayers, even though the transactions complied with the specific requirements of each of the relevant provisions. The result in *Mathew* can be contrasted in some respects with that in *Landrus*,[88] where the issue was whether certain provisions that prevented taxpayers from claiming losses on transfers to related persons evidenced a general policy in the Act regarding dispositions to related persons.

In finding for the taxpayer, the Tax Court reasoned in *Landrus* that the Act contained a detailed series of provisions to deny losses that would otherwise be allowed,[89] and that the provisions cited by the minister fell short of evidencing such a general policy. The Federal Court of Appeal affirmed these reasons, concluding that GAAR did not apply because a "real economic loss" resulted from the transactions under review and the underlying scheme of the Act allowed for the deduction of that

83 *Geransky v. The Queen*, 2001 CanLII 480, at paragraph 42 (TCC). See also Hoffmann, supra note 52, at 205: "It is one thing to give the statute a purposive construction. It is another to rectify the terms of highly prescriptive legislation in order to include provisions which might have been included but are not actually there."

84 *Gwartz v. The Queen*, 2013 TCC 86, at paragraphs 54-57.

85 Ibid.

86 *OSFC Holdings*, supra note 49, at paragraph 117.

87 Supra note 22.

88 *Canada v. Landrus*, 2009 FCA 113.

89 Paragraph 40(2)(e), subsection 85(4), and subsection 85(5.1).

loss.[90] The court also commented more broadly on the role of specific anti-avoidance provisions, stating that if such provisions can be demonstrated not to apply in a particular situation, this does not, in and of itself, indicate that the result was condoned by Parliament.[91]

The Federal Court of Appeal affirmed this approach in *Lehigh Cement*[92] when it considered whether a series of transactions resulted in a misuse or abuse of the withholding tax exemption in former subparagraph 212(1)(b)(vii). Sharlow JA, writing for a unanimous court, stated that the fact that an exemption could "be claimed in an unforeseen or novel manner . . . [did] not necessarily mean that the claim [was] a misuse of the exemption."[93] Her reasoning was that the court could not (at least on the extrinsic evidence before it) discern from the provision itself, the surrounding statutory scheme, or any other provision of the Act, a clear policy that would deny the exemption claimed. This was a curious result to the extent that the Court of Appeal expressly acknowledged in *Lehigh Cement* that *any* statutory exemption, even one as detailed and specific as the one in question, could not possibly describe every transaction within the intended scope of the exemption.

These decisions are arguably difficult to reconcile with other cases where GAAR *has* rounded out the rough edges of specific provisions, the most recent example being *Copthorne Holdings*.[94] There were several issues at play in this case, including whether certain transactions entered into by the taxpayer for the purpose of "preserving" (or, as the lower courts found, "duplicating") paid-up capital[95] were part of the same series of transactions as a tax-free redemption of shares made by the taxpayer's non-resident shareholder two years later, and whether that series offended certain provisions in the Act respecting the calculation of paid-up capital.[96] Despite the various technical arguments that were raised and considered in relation to each of the thresholds under GAAR, all three levels of court concluded that the transactions circumvented the purpose of a specific provision (that is, achieved a result

90 *Landrus*, supra note 88, at paragraph 68.

91 Ibid., at paragraph 47.

92 *Lehigh Cement Limited v. Canada*, 2011 FCA 124.

93 Ibid., at paragraph 37.

94 Supra note 2.

95 Paid-up capital represents capital invested in a class of shares of the corporation by its shareholders. When that class of shares is redeemed by the corporation in whole or in part, the amount paid by the corporation to the shareholders in excess of the paid-up capital attributable to the redeemed shares is deemed to have been paid as a dividend that must be included in the income of the recipient shareholder. However, the portion relating to paid-up capital need not be included in the income of the recipient shareholder because it is viewed as a return of capital to the shareholder.

96 The notion of paid-up capital in subsection 89(1) derives from the notion of "stated capital" found in many Canadian corporate statutes and is adjusted for specific transactions.

that the provision was intended to prevent)[97] and therefore abused the statutory scheme reflected in that provision.

What do these cases tell us about the scope of GAAR as it relates to other, specific provisions? First, specific provisions are meant to work in tandem with GAAR: each provides a context that assists in determining the scope of the other. Second, taxpayers *can* enter into transactions that have been structured to take advantage of specific provisions. The purpose of GAAR, although broadly expressed, is not to outlaw transactions that simply involve the use of such provisions. Third, there cannot be abusive tax avoidance if the only allegation is that a taxpayer abused some broad policy that is itself not grounded in the provisions of the Act. And finally, where the transactions in issue do not otherwise conflict with the policy of the provisions relied upon, and a specific anti-avoidance provision fails to provide a precise remedy, GAAR may not be used to fill the gap.

Making the Right Choices

The last of the more significant considerations in the GAAR analysis relates to the reach and impact of GAAR in circumstances where a taxpayer is faced with economically equivalent choices. The case law establishes that, in such circumstances, the taxpayer is not required to structure its affairs in a manner that results in the least favourable tax consequences.[98]

The decision in *Canada Trustco* exemplifies this principle. That case involved a leveraged sale-leaseback transaction in which capital cost allowance (CCA) was claimed on depreciable property that was acquired in an arrangement in which the taxpayer had only minimal risk. The Crown asserted that the taxpayer was not entitled to the deductions claimed because the structure of the arrangement contravened the policy of the CCA regime. The Crown argued that this regime was intended to permit deductions based only on the "real" or "economic" cost incurred by the taxpayer, and not on the "legal" cost (the purchase price paid by the taxpayer).

The Supreme Court disagreed, concluding that the CCA regime used "cost" in a sense that was well established and that it permitted the deduction of CCA based on that meaning of cost. Moreover, the Tax Court, after considering all of the circumstances, had found that the transactions were not so dissimilar to an ordinary sale-leaseback arrangement as to take them outside the policy of the CCA regime.[99]

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97 Subsection 87(3).

98 *Rousseau-Houle v. The Queen*, 2001 CanLII 695, at paragraph 50 (TCC). See also *Geransky*, supra note 83, at paragraph 40, per Bowman J (as he then was): "What is a misuse or an abuse is in some measure in the eye of the beholder. The Minister seems to be of the view that any use of a provision is a misuse or an abuse if the provision is not used in a manner that maximizes the tax resulting from the transaction. . . . I see no reason whatever why a taxpayer is obliged to follow that route." The logic of this proposition is grounded in the concept of tax neutrality, which dictates that functionally equivalent transactions be taxed in the same fashion and requires the equal treatment of taxpayers in similar circumstances.

99 *Canada Trustco*, supra note 11, at paragraph 89.

The taxpayer could have implemented a standard sale-leaseback transaction, and it would have been entitled to deduct CCA if it had done so. Therefore, the fact that the arrangement would not have been undertaken by the taxpayer but for the availability of CCA did not detract from its characterization as a legitimate, commercial arrangement.[100]

In defining the constraints that GAAR invariably imposes on taxpayer choices, the decision in *Lipson* is also apposite. In that case, the Supreme Court examined a series of transactions that were carried out entirely for tax purposes and that achieved exactly the outcome that the provisions in issue were intended to prevent. The taxpayer in *Lipson* sold shares of a family corporation to his wife, who, in turn, funded the purchase with loan proceeds. The very next day, the taxpayer and his wife purchased a home with the funds that the wife had used to acquire the shares. The taxpayer and his wife took out a mortgage on the home, and the mortgage proceeds were used to repay the original share-purchase loan. In computing his income, the taxpayer included in his income the dividends attributed to him from the shares that his wife purchased, and deducted interest on the mortgage.

In affirming the lower court decisions, LeBel J for the majority of the Supreme Court concluded that the transactions in issue, which were conceded to be avoidance transactions, were abusive because the overall result of the series frustrated the policy of the attribution rules. Binnie J, writing in dissent (Deschamps J concurring), would not have applied GAAR. He was of the view that the Crown had failed to identify any specific policy that was clearly frustrated by the series of transactions. Having reviewed each step in the series and the purpose of the relevant provisions, he concluded that the description provided by the majority of what those provisions were designed to prevent was actually what they were designed to permit. Rothstein J separately dissented on the basis that GAAR is a residual provision and should not have applied since a specific anti-avoidance rule was applicable.[101]

Although the Supreme Court was divided in *Lipson*, it confirmed the interpretive framework set out in *Canada Trustco*. That approach has been applied in subsequent decisions, and was reaffirmed by the Supreme Court in *Copthorne Holdings*, as discussed above. The disputed paid-up capital in that case arose from funds invested in a Canadian parent company and in its subsidiary, giving rise to paid-up capital on the shares of both companies. A reorganization was later undertaken, which involved an amalgamation. Had the amalgamation been implemented in vertical form, the shares of the subsidiary and the corresponding paid-up capital would have been eliminated for corporate-law and tax-law purposes.[102] Accordingly, the decision was made to sell the shares at fair market value to another corporation in the group, allowing for a horizontal amalgamation.

100 Ibid., at paragraph 85, per Miller J: "The tax did drive the deal, but it was a financing deal."

101 Subsection 74.5(11).

102 Subsection 87(3).

On appeal, the taxpayer argued that the lower courts had engaged in a results-oriented analysis and ignored the legal form of the transactions, treating an amalgamation that was horizontal both in fact and in law as a constructive vertical amalgamation. There was nothing in the Act, the taxpayer argued, to deprive it of the choice between the two forms of reorganization and required it to fritter away a valuable tax attribute by implementing a vertical amalgamation. However, the Supreme Court unanimously held in favour of the Crown and concluded that GAAR applied to deny the benefit of that tax attribute to the taxpayer.

The court focused on subsection 87(3), which provides, in its parenthetical clause, that the paid-up capital of the shares of an amalgamating corporation held by another amalgamating corporation is cancelled. In this case, the sale that allowed for the horizontal amalgamation circumvented the application of that parenthetical clause and, in the context of the overall series, achieved a result that the provision was intended to prevent. As a result, the taxpayer was found to have defeated the underlying rationale of the scheme pertaining to the cancellation of paid-up capital upon an amalgamation.

What can we conclude from a review of these decisions? For one thing, the general principle remains in effect:[103] A taxpayer is still entitled to select between creative courses of action that will minimize its tax liability[104] and, if challenged, is required to be taxed on the basis of what it actually did, as opposed to what it could have done or what a less sophisticated taxpayer might have done.[105] As with all principles of general application, however, there are exceptions. Indeed, the less than forgiving outcomes of recent decisions indicate that the hallmarks of legitimate tax planning are not as abstract as the rhetoric of GAAR may suggest. If nothing else, a healthy dose of skepticism should ensure that taxpayers are not caught off guard when engaged in the sort of planning that tax administrators are likely to contest.

CONCLUSION

To apply as intended, GAAR must distinguish clearly between legitimate and abusive tax avoidance. Not as clear, however, are the grounds on which that distinction should be made. It is easy enough to assert that taxpayers should engage responsibly in tax planning and steer clear of those borderline cases that are susceptible to scrutiny. But the Act has not yet succeeded, and may never succeed, in framing its limits

103 See *Spruce Credit Union*, supra note 16, at paragraph 93, per Boyle J: "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."

104 *Copthorne Holdings*, supra note 2, at paragraph 65, per Rothstein J: "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."

105 *Shell*, supra note 67, at paragraph 45.

in such a precise way. Advocating for a more pragmatic approach to GAAR does not guarantee that, in any given case, a court will not prefer an interpretation of the Act that best reflects its own perceptions. Nor is there any reason to assume that, in choosing between competing interpretations, courts will remain immune to subjective considerations. However, morality has a limited role to play in the resolution of GAAR cases. In this context, courts may well be inclined, and may even be driven on occasion, to achieve results that observers would commend as sensible. It nonetheless remains that their decisions must be grounded in the facts and supported by reasons that are justifiable in principle.