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Going for the Jugular: Justice Bowman's Approach to the Craft of Judging

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INTRODUCTION

Justice Bowman excelled at the judicial craft. The intelligence and good sense reflected in his decisions, as a judge and later chief justice of the Tax Court of Canada, are unlikely to be matched. Even though he was a prolific author of tax opinions, his judgments are almost always exemplary: they reflect an encyclopedic knowledge of tax law and a deep understanding of the policies and principles that animate that law; they are lucid and free of jargon, carefully crafted and logically structured; and the reasoning process is always honest and open-ended, reflecting intellectual humility and candour, emphasizing concrete considerations, acknowledging conflicting positions, and eschewing makeweight arguments that skirt hard issues. In addition, as a welcome reprieve from the sometimes ponderous and bland pronouncements present in tax cases, the judgments of Bowman J are laced with wit and humour. Over the years, we have made extensive use of them in teaching tax law. They have left an indelible mark on our students. A comprehensive and outstanding tax-law casebook

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could be compiled using these judgments alone. Bowman J leaves an astounding legacy of decided tax cases ranging over all aspects of the federal tax system.

In this article, we pay tribute to two aspects of Bowman J's judgments: his ability to grasp the central issue in tax cases and the pragmatic reasoning he applied in resolving those cases. These qualities distinguish his approach to judging from the more formalistic judicial style reflected in many contemporary decisions of the Supreme Court of Canada. Moreover, we believe that Bowman J's approach is the correct one. Thus, the publication of this collection of articles in his honour provides us with another chance to advance the case for pragmatism in judging.

The Canadian tax literature of the past 20 years or so is replete with debates over the appropriate approach to deciding tax cases. The debate has been provoked in the main by the fact that a number of Supreme Court justices have openly grappled with and offered their opinion on the issue, and it appears to be interminable. However, since the issue is an important one, and there is such a marked contrast between Bowman J's approach to tax cases and that of some Supreme Court judges, it seems suitable, and not inappropriately opportunistic, to revisit the debate on this occasion.

Legal pragmatism and legal formalism, as approaches to deciding cases, are surprisingly difficult to define succinctly. Even the proponents of each of these judicial philosophies do not seem to agree among themselves on their precise meaning. Nevertheless, legal pragmatism might be understood as an approach to judicial reasoning that entails basing judgments primarily on the consequences or the effects of the decision to be made. In contrast, legal formalism might be defined as an approach to judicial reasoning that does not involve thinking about the consequences of the decision or the purpose of the rules. Formalism rests on the belief that legal reasoning is distinct from modes of reasoning involving normative or policy considerations. It involves resolving cases by deduction from premises; for example, in cases involving statutory interpretation, formalism is associated with the plain meaning approach, whereby words or phrases used in the tax statute are given the meaning they have in everyday usage and the holding in the case is then derived deductively from this meaning.

These short definitions of pragmatism and formalism are clearly inadequate even for the limited purpose of contrasting Bowman J's approach to resolving tax cases with that of a number of Supreme Court justices. A brief elaboration of how the two approaches might be characterized by their proponents may provide a better sense of the differences between them. Formalistic judges regard judicial reasoning, even in hard cases (which would include most adjudicated tax cases), as an exercise in applying or following rules. Pragmatic judges regard judicial reasoning as being directed to the formulation of rules. Judges committed to legal formalism regard legal reasoning as a distinctive form of reasoning. Pragmatic judges regard judicial reasoning as simply one form of practical reasoning, no different in kind than the decision making required in all areas of public policy, or indeed all areas of problem solving; that is, it involves formulating the alternative ways of resolving the issue in question, predicting the consequences or outcomes of each alternative, and then choosing the most appropriate result in the light of the purpose of the particular exercise and the relevant evaluative criteria. Formalistic judges assume that their role is entirely distinct from that of the legislature: the role of the judge is simply to apply the law as formulated by the legislature. Therefore, the legislature must assume sole responsibility for the quality of the law. Pragmatic judges recognize that in discharging their judicial responsibilities, judges are engaged in a cooperative law-making function with the legislature. By filling gaps, settling ambiguities, and resolving conflicts in the law, judges assist legislators in formulating reasonable and rational laws. Put another way, the role of the judge is to complete the work of the legislature in the context of specific cases that in most instances were not anticipated by the legislature. Pragmatic judges recognize that they have a significant responsibility for the quality of the law.

Judges have three responsibilities in deciding tax cases: first, they have to attribute a usage to the words in the statute; second, they have to characterize the transaction at issue for tax purposes; and third, they have to determine whether the transaction is a tax-avoidance transaction that should be ignored for tax purposes. A copious literature debates the right approach to each of these aspects of a judge's craft, but in terms of contrasting pragmatism and formalism, each can be aligned along a simple metric. When engaging in statutory interpretation, a judge committed to legal formalism normally attributes a usage to the words in the tax statute by examining how a particular word has been used in some other context (determining its plain meaning) and then assumes that the same usage applies in the tax statute. A pragmatic judge examines the consequences of adopting one usage as opposed to others and assigns the word a usage that, given the structure of the tax legislation, achieves the most appropriate consequences in the light of tax principles. In characterizing the taxpayer's transaction, a formalistic judge simply determines the substantive legal rights and obligations that the taxpayer has created. Since the whole point of income tax law is to tax individuals on the basis of changes in their economic position, a pragmatic judge is more likely to be prepared to examine the economic substance and effect of the relevant legal transactions. If a transaction fits within the clear wording of the tax statute, and the parties have created the requisite private rights and obligations, a judge committed to legal formalism will be reluctant to set aside a transaction even though its only purpose is the avoidance of tax. A pragmatic judge, by contrast, is likely to feel some responsibility for discouraging taxpayers from abusing the law and therefore is more likely to set aside a transaction as impermissible tax avoidance if it was engaged in only for tax-avoidance purposes and if it resulted in a mismeasurement of the taxpayer's economic income, amounted to an abuse of the provisions of the tax legislation, or reached a result contrary to sensible tax policy.

Even this brief elaboration on the differences between pragmatic and formalistic judges is oversimplified. Further, our characterization of Bowman J as a pragmatist and many Supreme Court justices as formalists is a caricature. Bowman J was not as pragmatic as we would have liked, and many Supreme Court justices insist that they are not legal formalists. Nevertheless, this simplification is a useful starting point in understanding Bowman J's contribution to Canadian tax law and in distinguishing his approach from that of the Supreme Court.

Although this is not the place to rehearse the arguments, to fully reveal our theoretical hand, we believe that judges should always consider consequences in reaching their decisions,[1] should always characterize transactions with regard to their economic substance, and should be quick to set aside tax-avoidance transactions. Consequently, referring to Bowman J as a pragmatist is meant to be the highest compliment. We do not claim that he would agree with us either about our characterization of his judgments or about how the tax issues he confronted should have been resolved. (We don't agree with one another on many of these issues.) In fact, even more than pragmatism, what so clearly distinguishes his judgments is his sense of proportion. His approach to judicial decision making was multifaceted—in fact, too multifaceted for our taste. We would have preferred that he concentrate more on consequences, on economic substance, and on striking down tax-avoidance transactions, but others will view his multifaceted approach as his great strength.

Our claim is simply that Bowman J's pragmatism is a helpful starting point for understanding the themes that run through his judgments. He unquestionably had an uncanny ability to see the central issue in the tax cases that came before him, and he generally adopted a results-oriented approach in resolving those issues, drawing on his vast knowledge of tax law, his sensitivity to tax principles, and his innate common sense. He himself summed up what we see as one of the most important characteristics of his judgments in a Canadian Tax Foundation discussion on selecting counsel in tax cases. He advised that in choosing counsel, taxpayers should

> find someone who is practical, not an academic—someone who can see the essence of a case and go for it. . . . A judge or, in this case, a lawyer who can see the jugular vein and go for it is the ideal lawyer.[2]

While on the Tax Court of Canada, Bowman J wrote over 700 decisions. In this article, we examine a small sample of that remarkable body of work: six well-known decisions that were eventually appealed to the Supreme Court of Canada. Although these are not necessarily the best cases to illustrate Bowman J's pragmatism,[3] we

1 Elsewhere, one of us has argued that most approaches to statutory interpretation, other than pragmatism, are incoherent and that if judges relied more upon the consequentialist approach, it would "strengthen judgments; make results more accessible, predictable and objective; increase the efficiency of the litigation process; allow for the improvement of legislative drafting; increase the justice, neutrality and simplicity of the tax system; and more fully employ the unique skills and institutional competence of judges." Neil Brooks, "The Appropriate Role of Courts in Interpreting GST Legislation: Reflections on the Canadian Experience" (2006) vol. 6, no. 1 *Australian GST Journal* 1-26.

2 The Honourable Donald George Hugh Bowman, Ian MacGregor, Al Meghji, the Honourable Karen R. Sharlow, Elaine S. Sibson, and Joanne E. Swystun, "Tax Tales: A Conversation with Judges and Counsel," in *Report of Proceedings of the Fifty-Fourth Tax Conference*, 2002 Conference Report (Toronto: Canadian Tax Foundation, 2003), 33:1-28, at 33:5.

3 When one surveys the full range of tax cases decided by Bowman J, it is striking how often he imaginatively patched up the tax legislation and made it coherent in terms of tax principles. In

have chosen them because they enable us to compare his approach to judicial reasoning with that of several justices of the Supreme Court. Further, since these are the cases that tax lawyers are most familiar with, we can stylize their facts and not deal in depth with their holdings. The six cases are discussed in the order in which they were decided by Bowman J.

IKEA (1993)[4]

A shopping mall paid Ikea a large amount to induce it to enter into a 10-year lease of premises at its mall. Ikea argued that this tenant inducement payment was a tax-free capital receipt, or alternatively that if the payment was taxable, it should be included in its income over the life of the lease, consistent with how Ikea accounted for the portion of the amount not used to make leasehold improvements in its own financial statements.

In terms of tax principles, the resolution of both of these issues is relatively straightforward. In fact, if judges routinely applied a pragmatic approach in their decision making, this case would never have been litigated. The reasons these kinds of cases are litigated is that many judges take a formalistic approach, and that approach is so unpredictable that taxpayers with resources are prepared to play the judicial lottery. Some early cases had suggested that a tenant inducement payment received by a business might not be taxable since it did not have a source or was received in relation to a capital asset (such payments were often misleadingly referred to as capital receipts). A pragmatic judge would find both of these positions laughable and recognize them as the result of early misguided and formalistic judicial thinking. The amount received by Ikea was clearly received by virtue of its business. That is to say, but for its business Ikea would not have received the amount. The amount was not received in relation to a capital asset. Hence, even accepting the conceptual distinctions made by early judges unfamiliar with tax principles, there is no reason why the payment should not be taxed as business income. The timing issue is similarly straightforward. The taxpayer's net wealth was increased by the full amount in the year it received the tenant inducement payment; hence, the payment should be fully included in income in that year.[5] For financial accounting purposes, the amount might be appropriately reported over the life of the lease, but the purposes

another article, one of us has noted how Bowman J, along with a number of his Tax Court colleagues, pragmatically resolved the many countless gaps, conflicts, ambiguities, and unanswered interpretive problems in the goods and services tax legislation. See Neil Brooks, "The Appropriate Role of Courts in Interpreting GST Legislation: Reflections on the Canadian Experience" (2006) vol. 6, no. 1 *Australian GST Journal* 1-19.

4 *Ikea Limited v. The Queen*, 94 DTC 1112 (TCC).

5 Arguably, the correct treatment would be to allow the present value of any future costs associated with earning the amount to be deducted in the year the tenant inducement payment is included in income; however, in cases of this kind, those expenses are usually unquantifiable, and in most cases, they are relatively insignificant.

of financial and tax accounting are different. The purpose of financial accounting is to provide investors and creditors with an indication of the future profitability of a business; the purpose of tax accounting is to measure annual changes in the taxpayer's net wealth. There is therefore no reason why financial and tax accounting principles should necessarily be the same.

Both Bowman J and the Supreme Court reached the right result in this case, holding that the tenant inducement payment was income and was taxable in the year of receipt. Although his decision was based upon a careful parsing of the relevant jurisprudence, Bowman J wrote a pragmatic judgment. First, he noted that the accounting treatment that the taxpayer adopted in this case, even if appropriate, was of limited value in determining the correct tax result. What matters are tax principles, not accounting principles. He noted that "the accounting treatment does not create reality" but that it might be of "some marginal assistance in income tax cases" by providing "some indication of the underlying commercial and economic reality" of a transaction.[6]

In holding that the tenant inducement payment was business income, Bowman J might have simply applied a "but for" test (the taxpayer would not have received the amount but for its business). Although he did not use this simple and effective test for determining whether the income was business income, he did find that the payment arose out of a transaction (negotiating the lease) that was an integral part of operating the business, and that "nothing in the evidence links any part of the payment . . . to anything that could be described as capital."[7] He noted the Canada Revenue Agency's (CRA's) earlier practice of treating some tenant inducement payments as non-taxable capital receipts and expressed uncertainty about "where this view originated."[8] Pragmatic judges are often mystified by the sense of formal doctrines that are clearly at odds with basic tax principles. In terms of the consequences of not taxing the amount, Bowman J devoted a good deal of his judgment to analyzing the relationship between the lease inducement payment and the rent to be paid by the taxpayer. Ultimately, after reviewing evidence that suggested that where a tenant receives a lease inducement payment, that payment is likely captured in the cost of increased rents over time, he concluded that the lease inducement payment was "an integral part of the overall economic package negotiated by the parties."[9]

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6 Supra note 4, at 1116. Unfortunately, Bowman J did pick up on a distinction that some earlier cases had made between generally accepted accounting principles and well-accepted principles of business practice, and, following the Supreme Court, he suggested that the latter might have some relevance for tax purposes. This is a peculiar distinction, bizarre some might say. What are well-accepted principles of business practice? Why do they differ from generally accepted accounting principles? How does one determine them? Most importantly, whatever they are, why should they be of any relevance in applying tax principles?

7 Ibid., at 1124.

8 Ibid., at 1121.

9 Ibid.

One obvious consequence of an alternative holding would be that in many cases parties to a lease arrangement could reduce their overall tax liabilities by converting rental payments into tenant inducement payments.

On the timing issue, at trial the taxpayer presented expert accounting evidence justifying its accounting treatment of the amount, namely, the deferral of its tax liability over the life of the lease. This is of course the appropriate accounting treatment of prepaid amounts, since to accurately reflect the profits of a business as a going concern, the receipts should be matched with the expenses incurred in earning them. However, in this case it was not obvious that even for accounting purposes the tenant inducement payment could have been characterized as prepaid income, and Bowman J was deeply troubled by the lack of an articulated accounting rationale for the treatment. Nevertheless, he finessed the issue of the proper accounting treatment by holding unequivocally that because the purpose of tax accounting is different than the purpose of financial accounting, tax accounting does not necessarily follow financial accounting. His judgment has become one of the main references for this proposition. For tax purposes, he found that the amount had the quality of income when received since the taxpayer had the right to use and enjoy the income without restriction; or put another way, in terms of tax principles, the taxpayer's net wealth had increased by the amount of the payment.

There is no significant contrast between the judgment of the Supreme Court and Bowman J's judgment in this case, since basically the Supreme Court—quite sensibly—adopted his judgment. Iacobucci J, writing for a unanimous court, did acknowledge "the great assistance provided by the lucid and comprehensive reasons of Bowman, J."[10] However, the court's reasons for judgment rely so heavily on Bowman J's analysis that, even though Iacobucci J offered an explanation for writing a judgment, it is a bit of a mystery why the court bothered publishing separate written reasons.

CONTINENTAL BANK (1994)[11]

The Continental Bank of Canada sought to sell one of its wholly owned leasing subsidiaries as part of the dissolution of its business. Like any purchase and sale of a business, the transaction could have been structured as a sale of shares or a sale of assets. Normally, the vendor prefers a sale of shares since the gain will be taxed as a capital gain, whereas with a sale of assets at least part of the sale price will be taxed as business income, often representing the recapture of depreciation. (In this case, a sale of the leasing assets would have resulted in $84 million of recaptured capital cost allowance.) A purchaser normally prefers a purchase of assets since it acquires depreciable assets at their fair market value. The CRA will normally be indifferent as to which method of structuring the sale is chosen, since the purchaser's stepped-up

10 98 DTC 6092, at 6096 (SCC).

11 *Continental Bank of Canada et al. v. The Queen*, 94 DTC 1858 (TCC).

cost base in the case of a sale of assets will be balanced by the vendor's additional tax paid on the recapture of the excess capital cost allowance previously claimed as an expense. In this case, the parties initially agreed on a sale of shares, but the purchaser became concerned about the subsidiary's potential tax liabilities and insisted on an asset sale instead.

Even though the parties wished to structure the transaction as a sale of assets, so that the purchaser would not be burdened with the potential tax liabilities of the subsidiary, for tax purposes they wished to achieve the same results that would be accomplished with a sale of shares; namely, the vendor would realize any gains as a capital gain and would not be required to recapture any previously claimed capital cost allowance, and the purchaser would acquire the assets at their undepreciated capital cost to the vendor, not at their fair market value. To achieve this result, the parties engaged in a somewhat convoluted transaction. Continental Bank's subsidiary and two subsidiaries of the purchaser formed a partnership. The leasing assets in Continental Bank's subsidiary were then rolled into the partnership under subsection 97(2) of the Income Tax Act[12] in return for a 99 percent partnership interest. Continental Bank then wound up its subsidiary and under subsection 88(2) acquired the partnership interest at its cost, which equalled the undepreciated capital cost of the assets rolled into the partnership. Continental Bank sold its 99 percent interest in the partnership to the purchaser, realizing a capital gain on the difference between its cost of the partnership interest and the sale price. The gain was almost the same as the capital gain that Continental Bank would have realized if it had sold the shares of the subsidiary directly. The purchaser and its subsidiaries then wound up the partnership, acquiring the leasing assets at their undepreciated capital cost. This was of course the cost that they would have had in the leasing assets if they had bought the shares of Continental Bank's subsidiary. Consequently, even though the transactions resulted in a sale of assets, the tax consequences almost exactly replicated the sale of the shares of Continental Bank's subsidiary.

Taking a purely consequentialist approach to this transaction, it is difficult to see why the CRA found the transaction offensive. In terms of tax principles, the Act clearly contemplates two types of acquisitions: first, an acquisition in which cost basis and other tax attributes of a business carry over in the acquisition transaction, as occurs most obviously with a simple purchase of shares; and second, an acquisition in which the tax attributes do not carry over but instead the business assets purchased acquire a cost basis equal to the value of the acquisition transaction, as occurs most obviously with a simple purchase of assets. Since the legislation effectively allows the parties to the purchase and sale of a business to elect either a carryover-basis acquisition or a cost-basis acquisition, depending upon whether they structure the transaction as a share sale or an asset purchase, it is difficult to see why the CRA should be concerned with the form of the transactions that the parties go through

12 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.

to achieve one result or the other. Put another way, in this case since the parties had non-tax reasons for not engaging in a sale of shares, why should the CRA have been concerned if they were able to replicate the tax results of a sale of shares through the use of a partnership?

The CRA argued that the transaction should be treated in substance as a sale of assets and therefore Continental Bank should be required to include the difference between the sale price and the undepreciated capital cost of the leasing assets in its income as business income. In support of this result, it attacked the transaction on a number of grounds: the partnership was illegal since the taxpayer was a bank and under the Bank Act[13] could not enter into a partnership; the transaction was a sham; the partnership, which was in existence for only three days and was clearly established only for the purpose of facilitating the tax-planning arrangement, was not in fact a partnership since it was not carrying on a business with a view to profit; in economic substance the transaction was a sale of assets; the use of the partnership rollover provision (subsection 97(2)) for the purposes of this transaction was contrary to the spirit and object of that provision; and, in the alternative, the sale of the partnership interest by Continental Bank should be treated as income from a business and not as a capital gain since the bank held the partnership interest for only three days and clearly acquired it with the intention of selling it at a profit.

Bowman J seems to have been somewhat amused by this case. He noted that there were some problems with the documentation and that the transactions seemed to have been done in a great hurry in late December, and he wondered whether this was due to the "impending festive season."[14] He also noted that as a way of replicating the tax consequences of a sale of shares, the tax plan used by the bank had been "bruited about for years but I have never heard of its being done and, if anyone ever did have the temerity to try it, never with such speed, aggressiveness or on so grand a scale."[15] However, in spite of the convoluted nature of the transaction, Bowman J recognized that the tax planning did not result in a mismeasurement of income or a deferral not contemplated by the legislation. He explained:

> 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.[16]

13 RSC 1985, c. B-1.

14 Supra note 11, at 1864.

15 Ibid., at 1862.

16 Ibid., at 1866-67.

In a classic Bowman judgment, which could be used as a textbook description of tax-avoidance doctrine, he then carefully reviewed each ground that the minister put forward for setting aside the tax-planning transaction and showed that none of these grounds justified setting aside this transaction given that, in the light of the tax consequences, it did not constitute "fiscal gimmickry."

By the time the case reached the Supreme Court, the issues were focused almost exclusively on the validity of the partnership. The Supreme Court reviewed at great length—entirely divorced from the tax consequences of the outcome of the case—the question of whether a valid partnership had been created in private partnership law and whether the partnership was invalid since under the Bank Act a bank is prohibited from directly or indirectly being a member of a partnership. Bowman J had sensibly disposed of these issues in a couple of paragraphs. The Supreme Court upheld his judgment, but by divorcing its discussion from the larger factual context of the case, unfortunately it validated the use of partnerships structured purely for tax avoidance.

To highlight aspects of Bowman J's judicial style by contrasting it with that of the Supreme Court, we might make two somewhat parenthetical observations.

First, as in this case, the Supreme Court often seems to get derailed onto a side issue in tax cases and then writes a legalistic-sounding treatise on the issue. One wonders if this practice might be in part due to the court's reliance on legal clerks in preparing its judgments. Bright as they are, legal clerks are less likely to be able to spot the jugular in these complex cases, and the one thing that they are likely relatively skilled at (given their inadequate legal training in pragmatic decision making) is writing legalistic-sounding justifications (much as they would on a law exam) for the legal issues they have spotted.

Second, although many Supreme Court judges write as if they were deriving their results from the application of rules or the plain meaning of words, in fact their decisions are likely often as driven by their consequences as are the decisions of more overtly pragmatic judges like Bowman J. As an illustration, in this case McLachlin J, writing for the majority, noted in support of her holding that the bank's participation as a partner did not render the partnership invalid, that otherwise "one would never know whether a partnership is valid without investigating all those who may own shares. . . . This would make it difficult if not impossible to do business with partnerships with any sense of security."[17] She also noted that "a further consequence of holding that an unlawful investment voids a partnership entered into by an investee is that the legal status of partnerships would vary with the shareholders in corporate partners."[18] As a result, she noted, "The only sensible rule is what I apprehend to be the legal rule."[19] One suspects it was the other way around: McLachlin J determined what the sensible rule was and declared that to be the legal rule.

17 98 DTC 6501, at 6508 (SCC).

18 Ibid.

19 Ibid.

SINGLETON (1996)[20]

The taxpayer in this case decided to purchase a home. As a partner in a law firm, he had an equity investment equal in value to the home he wished to purchase, but he preferred to retain that investment. In an attempt to claim a deduction for the interest on the money that he would have to borrow to buy the house, he did what every tax-savvy person in similar circumstances has been doing for many years: he liquidated his investment (withdrew funds from the partnership's capital account), used the proceeds to purchase the home, and then borrowed money to refinance his investment (repay the withdrawn funds to his capital account). Following these transactions, on the basis that the borrowed money was used directly to finance his law firm, he claimed the interest on the loan as a deductible business expense. The CRA disallowed the deduction. It argued that the borrowed money was used, in effect, to purchase a home and therefore the interest expense was a personal expense.

In terms of tax principles, interest is no different than any other type of expense. If it is incurred to earn income, it should be deductible; if it is incurred for a personal purpose, it should not be. Since money is fungible, the difficulty arises in determining whether the borrowed money that the interest relates to was used for a business or a personal purpose. This determination can be made in one of two ways. One way is to physically trace the use of the borrowed money to which the interest expense relates. If the borrowed money is used for a business purpose, the interest is deductible; if it is used for a personal purpose, the interest is not deductible. Tracing the use of borrowed money is difficult and clearly allows taxpayers to arrange their affairs in a tax-wise fashion. However, the only other possible way of determining the use of borrowed money and therefore the deductibility of the related interest is by making an arbitrary assumption about the use of borrowed money. For example, if a taxpayer has business or investment assets, it might be assumed that any money the taxpayer has borrowed has been used to purchase those assets (up to the value or the cost of the assets); therefore, any interest attributable to a loan of that amount would be deductible.

The Act does not dictate which method should be used in distinguishing between personal and business interest expenses. The relevant provision (paragraph 20(1)(c)) merely provides that interest is deductible if the borrowed money is "used for the purpose of earning income." The courts, the CRA, and most tax analysts have assumed that physical tracing should be used in distinguishing a personal from a business interest expense. If tracing is used, a further question is whether it should apply even though taxpayers have clearly arranged their borrowings to ensure that the borrowed money is used for business or investment purposes—for example, by selling investment assets and using the proceeds for a personal use and then borrowing to repurchase the investment assets. Again, the Canadian tax community has always assumed that tax planning is permissible in arranging the borrowings of

20 *Singleton v. The Queen*, 96 DTC 1850 (TCC).

taxpayers. Indeed, if this were not the case, it is not obvious what bright-line test might be used to distinguish between deductible and non-deductible interest expenses. Further, at least for borrowings by individual taxpayers, there are good policy reasons for preferring the tracing method over arbitrary apportionment and ordering methods. Among other reasons, tracing forces taxpayers who wish to rearrange their borrowings to realize any accrued gains on their investment assets. In view of the longstanding Canadian practice and sound policy reasons in support of tracing, it is difficult to know why the CRA reassessed the taxpayer in *Singleton*.

Bowman J was clearly troubled by this case and, in a short judgment, held that the interest was not deductible. There are two possible readings of his judgment as it relates to the sequence of the transactions. On one reading, Bowman J found that the borrowed money was paid into the law firm before the taxpayer withdrew capital from the firm. On this reading, it is possible to argue that the borrowed money was used to purchase the home (depending upon what assumption is made about the use of funds that have been commingled), and his holding is unexceptional. On the alternative reading, Bowman J found that the taxpayer withdrew capital from the firm to purchase the house and then borrowed to repay his capital contribution. If this was his finding, his holding is quite exceptional since it departs from the physical tracing rule and appears to adopt what might be described as an "overall economic substance use of the borrowed money" approach. Numerous quotations from the judgment suggest that the second reading is the correct one:

> On any realistic view of the matter it could not be said that the money was used for the purpose of making a contribution of capital to the partnership. The fundamental purpose was the purchase of a house and this purchase cannot be altered by the shuffle of cheques that took place.[21]

> The true purpose of the use of the borrowed funds subsumed the subordinate and incidental links in the chain.[22]

> One is . . . left with the inescapable factual determination that the true economic purpose for which the borrowed money was used was the purchase of a house, not the enhancement of the firm's income earning potential by a contribution of capital.[23]

Bowman J did not seem to appreciate that talk of "any realistic view," "the true purpose of the use," and "true economic purpose" is irrelevant in the application of a straightforward physical tracing rule. A tracing rule means that the use of borrowed money is physically traced. Period.

Perhaps as a pragmatic judge, Bowman J was troubled by the fact that under the strict tracing rule, two taxpayers with the same assets and the same cash flows both

21 Ibid., at 1852.

22 Ibid.

23 Ibid., at 1853.

before and after the purchase of a home could be in very different tax positions, depending upon how they arranged their financing. However, that is the effect of a physical tracing rule. Also, any other rule for allocating interest expenses between personal and business uses, or any attempt to graft an "economic purpose" test onto the tracing rule, will lead to equally arbitrary results.

The majority of the Supreme Court, in a judgment written by Major J, held that the money was borrowed to earn business income and the interest was deductible. Somewhat surprisingly, the court suggested that the exact ordering of the transactions was not relevant.[24] Also, unfortunately, although all the court had to do was to reaffirm the validity of the physical tracing rule in determining the use of borrowed money—which should have taken just a few sentences—it provided a lengthy discussion reaffirming generally the irrelevance of economic realities and bona fide purposes in tax planning. LeBel J, with Bastarache J concurring, wrote a long dissent that includes a learned discussion of the relevance of economic realities and the appropriate approach to statutory interpretation in tax cases. His dissent by and large responds to the general comments on these issues made in the majority judgment. He suggested that, considering "economic reality," the individual transactions were simply not created for the bona fide purpose of earning income, and that such an overt attempt to "artificially" meet the requirements of the Act should not be condoned.[25] He would have restored Bowman J's judgment.

All of this discussion in the Supreme Court's judgment seems beside the point. The legal issue was straightforward: Should a physical tracing rule be used to determine whether interest on borrowed money is a personal or a business expense? One might have expected a discussion of the alternative approaches that could be used in determining whether interest has been incurred for a business or a personal reason, the consequences of adopting each approach, and, in the light of tax principles, which approach is the most appropriate. It makes no sense to apply a notion of economic substance to an approach that is necessarily arbitrary.

GIFFORD (2001)[26]

The taxpayer was employed as a financial adviser. Upon a fellow employee's retirement, he agreed to purchase that employee's list of customers, and used borrowed funds to finance the purchase. The central issue in the case was straightforward: Could the taxpayer deduct the interest he paid on the borrowed money? The relevant employment expense deduction provision (paragraph 8(1)(f)) provides that employees can deduct current but not capital expenses. Hence, the issue was whether the interest paid was a current or a capital expense.

Over the years, the courts have dealt with this issue in different contexts, and by refusing to have regard to basic tax principles, they have always got it wrong. A long

24 2001 DTC 5533, at paragraph 5 (SCC).

25 Ibid., at paragraphs 49-58.

26 *Gifford v. The Queen*, 2001 DTC 168 (TCC).

line of cases have held that generally interest is a capital expense (and hence can be deducted currently only if allowed by a specific legislative provision). Another line of cases suggest that whether interest is a current or a capital expense depends upon the use to which the borrowed money is put: if the borrowed money is used for a revenue-generating purpose, the interest is a current expense; if the borrowed money is used to acquire a capital asset, the interest is a capital expense. Both of these positions are wrong. As a matter of basic tax principles, normally an interest expense is current. Interest is simply an amount paid for the rental of money. Amounts paid for the annual rental of property are always current: the rental expense is for the use of the property for the year only and results in no benefit beyond the year. Hence, the taxpayer's net wealth is reduced by the full amount of the rent (or interest) expense incurred in the year. A pragmatic judge would have found this case to be a slam dunk.

At trial, the taxpayer argued the case himself under the informal procedure of the Tax Court. For whatever reason, Bowman J took an interest in the central issue in the case (he had argued the issue as a tax counsel) and delivered a thoroughly researched and scholarly analysis, which presumably he undertook on his own initiative. Bowman J reached the correct result in this case, allowing the deduction of interest, but he did so for the wrong reasons. First, he found that the taxpayer had borrowed the money to finance a current expense, not to acquire a capital asset. Second, he held that an interest expense to finance a current expense is itself a current expense; only interest expenses incurred to finance capital assets are capital expenditures.

On the first issue, he reasoned that the customer list was not a capital asset since employees can have no ownership rights over their clients or a list of their clients. But ownership has nothing to do with determining whether an expense is current or capital. The sole test of whether an expense is current or capital is whether the expense will result in the earning of income in future years, and therefore at the end of the year in which it is incurred, its value has not been completely consumed in the business (resulting in the creation of an asset). Bowman J obviously appreciated this, since in addition to his conceptual reason for holding the expense to be current, he characterized clients as "fleeting, volatile and evanescent"[27] and analogized the expense incurred in this case to "a current marketing expense."[28] However, as a factual matter, expenses in relation to customer lists usually have some lasting value. In this case, as part of the purchase agreement, what amounted to a non-competition clause between the parties had a term of 30 months and a likely value even in excess of that period of time. Indeed, in this case the purchaser had undoubtedly assumed that the purchase of the list (or whatever rights he purchased) would have a value beyond the year or he would have never paid such a large sum for it. However, since

27 Ibid., at paragraph 13.

28 Ibid., at paragraph 11.

Bowman J was unwilling to go so far as to hold that all interest expenses are current, in order to reach the appropriate result, he obviously felt that he had to find that the purchase of the list was a current expense.

On the second issue—when an interest expense must be treated as a capital expense—Bowman J was faced with a considerable number of cases, including decisions of the Supreme Court of Canada, that at least suggested that this is always the case. He neatly distinguished these cases, and after referring to a few Privy Council and Australian cases, as well as the academic literature in Canada, he held that the character of an interest expense depends upon the use of the borrowed money. An interest expense is a capital expense only if the borrowed money is used to acquire a capital asset. If the borrowed money was used for a revenue-generating purpose (as he found it was in this case), it is deductible as a current expense.

In his pragmatic way, Bowman J clearly understood the correct result in this case. But he should have reached it in a much simpler way: annual interest expenses incurred in a business context are normally current.

On the first issue, the Supreme Court, adopting the reasoning of the Federal Court of Appeal, found that the purchase of the customer list was a capital expenditure. Although this is likely the correct finding, in making this finding Major J, writing for the court, considered a number of the conceptual tests outlined in *Johns-Manville*.[29] These tests seem to imply that the question of whether an expense is a current or a capital expense is a somewhat obscure legal question. In fact, it is a straightforward empirical question: Does the expenditure have a value at the end of the year? If it does, it is a capital expense. One of the most fundamental tax principles of an equitable income tax is that taxpayers should not be allowed to deduct their savings, no matter what form they take. To the extent that an expenditure results in the earning of income in future years, it represents savings. The so-called tests or factors set out in *Johns-Manville* never made any sense.

On the second issue, Major J was not so lucky (in terms of reaching the right result). The formalistic approach that he took led to a bizarre line of reasoning, which has been roundly criticized, and the wrong result. He focused on the wording of the relevant section, which provides that expenses are not deductible if they are "outlays, losses or replacements of capital or payments on account of capital." For whatever misguided reason, he latched onto the second phrase in the provision, "payments on account of capital," and assumed that it had a usage different than the first phrase, "outlays, losses or replacements of capital." He said that the issue was not whether the borrowed money was used to finance a current or a capital expense, but instead whether the borrowed money was used on account of capital. In finding that the money was used on account of capital, he said, "If the money adds to the financial capital then the payment of interest on that loan will be considered to be a payment 'on account of capital.'"[30] In this case, he found that the loan proceeds

29 Ibid., at paragraphs 19-22, citing *Johns-Manville Canada Inc. v. The Queen*, 85 DTC 5373 (SCC).

30 Supra note 28, at paragraph 39.

added to the financial capital of the taxpayer, and therefore the interest expense was a payment on account of capital.

Bowman J would never have made such a blatant conceptual error. Tax commentators have unanimously assumed that expressions such as "capital expense" or "capital expenditure," an "outlay of capital" or "of a capital nature," and "a payment on account of capital" all refer to the same type of expense, namely, one that has a value at the end of the year in which it is incurred. Whatever could have moved Major J to try to deduce the answer to the question that confronted him by assigning one of these phrases a usage different from the other frequently used terms? As a reflection of the formalism of the Supreme Court, it appears that no judge who heard the case asked some fundamental and very straightforward questions: "Why are we distinguishing between capital expenditures and payments on account of capital? What are the consequences of making this distinction? Does it make sense?" Certainly Major J does not even hint at what plausible function this distinction might serve, or why it is sensible to make this distinction in terms of tax principles, or for any other reason.

There has been an immense amount of scholarly writing on the proper tax treatment of interest expenses. Bowman J demonstrated a thorough familiarity with the scholarly debates in this area of tax law. Somewhat shockingly, the Supreme Court did not deal at all with the tax policy arguments relating to the appropriate tax treatment of interest expenses, or even bother to refer to the scholarly literature. Although Major J expressly admitted that the approach taken by Bowman J in this case was "in accordance with general accounting principles and logic," in his view such an analysis was not relevant for the purposes of Canadian tax law.[31] This highlights one of the important differences between a pragmatist and a formalist. To a pragmatist, experience and logic are always relevant in determining the law.

TSIAPRAILIS (2001)[32]

The taxpayer was an employee who was injured on the job. Pursuant to the collective agreement to which she was a party, she was entitled to long-term disability benefits under an insurance policy that was paid for by her employer. The insurance premiums paid by the employer were not included in the taxpayer's income since they are explicitly stated to be excluded from taxable employment benefits under paragraph 6(1)(a). When the taxpayer became disabled and began collecting monthly benefits under the policy, these payments were included in her income under paragraph 6(1)(f). At some point, the insurance company stopped making payments, alleging that the taxpayer was no longer totally disabled and thus no longer qualified to receive benefits under the policy. The taxpayer sued and the insurance company eventually settled her claim by providing her with a lump-sum payment. The issue

31 Ibid., at paragraph 38.

32 *Tsiaprailis v. The Queen*, 2002 DTC 1563 (TCC).

brought before the Tax Court was whether this lump-sum payment or any portion of it was taxable.

The basic principles for taxing employer-provided social welfare and wage replacement schemes are straightforward. Premiums paid for insurance relating to employment income are not a personal expense; therefore, employees should not have to include in their income the value of premiums paid by their employer. However, all benefits received under the policy should be taxable. If employees are required to include in their income the value of premiums paid by the employer, or if they pay non-deductible premiums on their own behalf, they should be allowed to recover these costs and only be taxed on benefits in excess of these amounts. By and large, the Act taxes these plans appropriately. Basically, under paragraph 6(1)(a) the premiums paid by employers for employee wage replacement plans are not included in the employees' income, and under paragraph 6(1)(f) amounts received from such plans are included in the beneficiaries' income. If employees pay a non-deductible amount for the premiums, they can recover this amount before the benefits become taxable. Although the basic scheme of the Act reflects sound tax principles in this area, the provisions that deal with employer-provided social welfare schemes are incomplete and do not use consistent terminology. Like many rules in the Act, these provisions have been added to and amended on an ad hoc basis over many years.

The basic principles outlined above suggest that the resolution of this case should have been easy. The employee did not include any of the employer-provided premiums in income as a taxable benefit; therefore, all payments from the plan as compensation for lost income should have been taxable. The problem is that the wording of the inclusion provision that applies to wage replacement plans is quite specific. Subparagraph 6(1)(f)(ii) provides that the following amounts have to be included in the employment income of employees:

> all amounts received by the taxpayer . . . that were payable . . . on a periodic basis in respect of the loss of all or any part of the taxpayer's income from an office or employment, pursuant to . . . a disability insurance plan.

The taxpayer argued that the lump-sum payment in this case could not be taxed under this charging provision for two reasons: it was not "payable . . . on a periodic basis" and it was not paid "pursuant to . . . a disability insurance plan."

The minister disputed the taxpayer's interpretation of subparagraph 6(1)(f)(ii) and also argued that, in any event, the lump-sum amount could be taxed under the general charging section for taxing employment benefits as "any benefit" received by virtue of employment.[33] Further, the minister argued that the amount could be taxed under the surrogatum principle, a general tax principle that holds that damage

33 Paragraph 6(1)(a).

awards and other settlements should be taxed in the same fashion as the payments for which they serve as a substitute.

After a lengthy review of the contract providing for the benefits and a review of the facts, Bowman J, in a relatively short discussion, held that the lump sum was not taxable. First, he held that paragraph 6(1)(f) had no application since "the lump sum . . . cannot on any basis of statutory interpretation be described as an 'amount . . . payable to the taxpayer on a periodic basis.'"[34] Second, he held that the minister could not rely upon the general charging provision for the taxation of employee benefits since, as a general matter of statutory interpretation, where a specific provision of the statute does not require a particular payment to be taxed, another more general provision should not be held to apply. He referred to the familiar canon of statutory interpretation: *expressio unius est exclusio alterius*.[35] While he admitted that "all principles of statutory interpretation—including Latin maxims of ancient vintage—should be treated with some caution,"[36] he found the principle compelling in this case. Third, he quoted Lord Diplock's classic statement of the surrogatum principle, but simply said, "I can see no reason for extending that rule . . . beyond the computation of income from a business."[37] He stated that extending the principle to a lump-sum payment that was not caught by the strict wording of paragraph 6(1)(f) would be "a distortion of the logic and common sense of the point that Lord Diplock was making."[38]

Then, revealing his sympathies in the case (which, as a testament to his sincerity, he often did in his judgments), Bowman J said:

> It is not this court's role to dream up imaginative ways of taxing disabled people on lump sum settlements that they receive from insurance companies. If Parliament thinks that its revenues are in jeopardy because it does not get its tax on such payments it can amend the legislation.[39]

Somewhat surprisingly, it appears that when the *Tsiaprailis* case reached the Supreme Court, the only portion of the settlement amount that the minister was still seeking to tax was the arrears of monthly benefits up to the date of the settlement. In a judgment remarkably divorced from any tax principles or common sense, the majority of the Supreme Court, in a judgment written by Charron J and concurred in by Bastarache, Binnie, and Deschamps JJ, held that the portion of the lump sum designed to compensate for accumulated arrears of past benefits was taxable but that

34 Supra note 32, at paragraph 18.

35 Ibid., at paragraph 19.

36 Ibid., at paragraph 20.

37 Ibid., at paragraph 24.

38 Ibid.

39 Ibid., at paragraph 25.

amounts paid to settle any future liability under the disability insurance plan were not. In holding the amount paid to compensate for the accumulated arrears taxable, the court relied upon the surrogatum principle, which it held, without any analysis, to apply not only to business income but to all awards of damages and settlement payments.[40] Since this portion of the settlement was designed to compensate for amounts that would be taxable under paragraph 6(1)(f) as periodic payments, under the surrogatum principle it should be taxable. However, the monies paid to settle any future liability under the disability insurance plan were not taxable for two reasons: first, they were not paid "pursuant to . . . a disability insurance plan" because under the terms of the policy there was no obligation to make lump-sum payments; and second, they were not "payable . . . on a periodic basis" but were in the nature of a capital amount.[41]

The dissent, in a judgment written by Abella J and concurred in by Major and LeBel JJ, reached the same result as Bowman J—namely, that the portion of the payment attributable to the arrears was not taxable—but by a different line of reasoning. According to Abella J's reasoning, that part of the payment was not taxable since it was paid, not pursuant to a disability insurance plan, but pursuant to a settlement agreement. She interpreted the phrase "pursuant to" to be equivalent to "in accordance with" and concluded that while "the lump sum settlement payment was not paid . . . 'in accordance with' a disability insurance plan, it was paid . . . 'in accordance with' a settlement agreement."[42] She also held that even if the surrogatum principle were applicable, the arrears portion would not be taxable: although the amount paid was calculated on the basis of the periodic payments that might have been made, it was not intended to replace those amounts but instead was intended to "release the insurance company from a claim that it was liable, and, concurrently, to extinguish Ms. Tsiaprailis' claim for entitlement under the disability insurance policy."[43] She went on to note that the insurance company "explicitly denied liability under the insurance contract" and that it disputed the insured's claim that she was "entitled to *any* payments under the policy."[44] Abella J also noted the importance of respecting "the legal realities of a transaction."[45]

The formalistic nature of this line of reasoning is staggering. If a taxpayer with a disability is entitled to periodic payments, why should the tax treatment differ depending upon whether the periodic payments are made on a timely basis, or a lump-sum payment is made to compensate for the arrears of periodic payments, or a lump-sum payment is made to discharge some or all of the obligation to make

40 2005 DTC 5119, at paragraph 7 (SCC).

41 Ibid., at paragraph 11.

42 Ibid., at paragraph 45.

43 Ibid., at paragraph 54.

44 Ibid., at paragraph 55.

45 Ibid., at paragraph 58.

future periodic payments? The only difference in these three situations is the timing of the receipt of the periodic payments. In terms of measuring the taxpayer's ability to pay, or the application of any other tax principle, there appears to be no reason to distinguish these amounts. None of the judges offered any reasons why a payment representing future periodic payments should not be taxable. In terms of the wording of the Act, in each of these situations, even though the payment is a lump sum, and whether it is paid voluntarily or as the result of the threat of legal action, the amount can easily be regarded as "payable on a periodic basis." That is to say, that phrase in most contexts could easily be understood as including a payment in lieu of a periodic payment.

Moreover, to suggest, as the dissenting judgment does, that a lump-sum payment to compensate for periodic payments is not made "pursuant to a disability insurance plan" but pursuant to a settlement agreement is the height of formalism. In cases such as this, why should tax consequences turn on whether agreements for the payment of lump sums are made voluntarily or as the result of legal threats, or even more bizarrely (as suggested in the dissenting judgment) whether the insurance company makes the payment but denies liability? The phrase "pursuant to . . . a disability insurance plan" can be read as requiring the payment to be made according to the precise terms of the agreement, but it can just as easily be read as covering a payment made as the result of having such an agreement. The court should have examined the consequences, in terms of tax principles, of either of these interpretations. Such an examination would suggest that there is no justification for the former interpretation.

In some judgments in *Tsiaprailis*, the judges applied the surrogatum principle, but that principle has no application in this case. Reliance on the principle is not necessary since the payments should be taxed as amounts that are payable periodically. No judgment provided justification for the application (or non-application) of the principle. Indeed, to the extent that the principle should have any relevance in tax cases, it should be confined, as it was in the English cases and by Bowman J in this case, to the basic and obvious principle that a surrogatum for a loss of profits is an income receipt.

Perhaps one of the underlying problems that caused so much confusion for the judges in this case is that the taxation of lump sums, particularly those that are meant to compensate for amounts that would otherwise have been received over a number of years, does not fit well into the scheme of the Act, which taxes the annual income of individuals at progressive rates. It is possible, depending upon the income of the taxpayer, that considerably more tax will be paid on the inclusion of a lump-sum amount than would be paid if the amount were received over a number of years. This problem is generally referred to as the bunching problem. The receipt of a large amount of money in one year may propel a taxpayer who would normally be subject to tax in one of the lower tax brackets into a higher bracket. However, a concern about the potential for bunching should not drive, either implicitly or explicitly, the reasoning supporting the tax status of a lump-sum payment. Years ago, when marginal tax rates climbed as high as 80 and 90 percent, general averaging provisions were common in income tax legislation, and the Act still contains some provisions designed to mitigate the bunching effect with respect to some lump sums.[46] However, lump-sum payments are taxed in many circumstances without relief. Exempting them from tax is a particularly inappropriate way to provide relief from bunching.

As a final point, the justices of the Supreme Court, as well as Bowman J, seemed to believe that they were assisting taxpayers with disabilities by making lump-sum payments not taxable. But why should such taxpayers who are able (for whatever reason) to convert periodic payments to which they are entitled into a lump sum receive a tax benefit compared with those who are not able to do so but continue to receive periodic payments? It is an odd tax expenditure for taxpayers with a disability. Moreover, this treatment ignores the difference between ex ante and ex post reasoning. Very likely, only the taxpayer who is granted the tax concession in this particular case will benefit (that is, there will be a benefit ex ante); however, in the future (ex post) one can assume that the tax benefits of making lump-sum payments not taxable will accrue to the benefit of the insurers in the form of reduced lump-sum payments, and even employers will benefit in the long term if the premiums they pay are experience-rated on the basis of the cost of claims. For these reasons, since the decision in *Tsiaprailis* results in such an odd tax expenditure, and given the opportunities that it presents for tax planning, one assumes that the legislature will have to try to rationalize this area of tax law.

LIPSON (2006)[47]

Lipson involved the same type of tax planning that was at issue in *Singleton*—namely, a taxpayer purchased a personal residence but attempted to arrange his affairs so that interest on the money that he borrowed to finance the purchase was deductible. In *Singleton*, the taxpayer withdrew his capital from his law firm, used the funds to purchase a residence, and then borrowed money to refinance the firm. In *Lipson*, the taxpayer had a business with a substantial amount of equity, but, unlike Singleton, he could not withdraw capital from the firm without paying tax on the withdrawn funds. Therefore, he adopted a well-known, and one assumes a frequently used (in the right circumstances), scheme for deducting the interest on the borrowed money.

Lipson's wife borrowed money and purchased her husband's shares in the corporation from him at their fair market value. Lipson used the proceeds from the sale of these shares to purchase the house. Somewhat surprisingly, there is an argument that as a result of these simple transactions, even though the taxpayer sold his shares for their fair market value, no capital gains tax was payable, and even though it was his wife who borrowed the money to earn investment income (the dividends paid on shares that she purchased from him), the taxpayer was able to deduct from his income

46 See, for example, sections 110.2 and 120.31.

47 *Lipson et al. v. The Queen*, 2006 DTC 2687 (TCC).

the excess interest expense incurred by his wife. This curious result arises because under subsection 73(1) a taxpayer can sell property to a spouse at its fair market value but for tax purposes be deemed to have sold the property at its adjusted cost base, and under section 74.1 any gain or loss realized on the transferred property in the hands of the transferee is attributed back to the transferor. In this case, the spouse realized a loss on her investment in the shares each year equal to the excess of her interest expense on the borrowed money over any dividends received from the shares.

Although *Lipson* and *Singleton* involved the same type of tax planning, the facts in *Lipson* are slightly different—"'*Singleton* with a spousal dimension'—or *Singleton* with a twist," as Binnie J put it in his dissent.[48] Moreover, the general anti-avoidance rule (GAAR) was not in force when *Singleton* arose but applied to the planning in the *Lipson* case. All parties agreed that Lipson had obtained a tax benefit and that the scheme was an avoidance transaction. The central issue on the appeal of the reassessment was whether or not allowing Lipson an interest deduction amounted to a misuse or abuse within the meaning of subsection 245(4).

The fact that the transaction amounted to a misuse of section 74.1 seems almost self-evident. The purpose of section 74.1 is to prevent income splitting between spouses. Lipson used the provision to deduct an expense that would have been a personal expense if he had incurred it himself. Moreover, the amount of expense that was deductible was entirely within his control since it depended upon the amount of dividends paid by the family holding corporation. If that is not an abuse of the section, it is hard to imagine what would be.

At the Tax Court, this case shows Bowman J at his best. Being a pragmatist, he was understandably offended by the artificiality of the transaction and the nonsense of it all, to the extent that he was somewhat swashbuckling in giving his reasons. He noted that the purpose of the interest deductibility provisions of the Act was "not . . . to assist in acts of fiscal *legerdemain* whereby a wife's temporary borrowing of funds to pay to her husband for shares whose tax incidents remain with the husband is replaced by a borrowing of funds that end up paying for a new house."[49] He stated, "It does strike me as passing strange that Earl [Lipson] should get a deduction for interest on money borrowed ostensibly to enable his wife to buy his shares"[50] and referred to the case as "an obvious example of abusive tax avoidance."[51] On the basis of the evidence, he questioned whether Lipson's wife had actually paid the interest due on the mortgage loan and whether it was correct to say that she acquired the shares for the purpose of earning income. But setting that aside, he looked at the overall purpose

48 2009 DTC 5015, at paragraph 56 (SCC).

49 Supra note 47, at paragraph 20.

50 Ibid., at paragraph 8.

51 Ibid., at paragraph 31.

of the series of steps that Lipson had engaged in and held that the transaction resulted in misuse of every provision of the Act implicated in the scheme. He carefully and thoroughly reviewed the purposes of each provision and concluded:

> Not one of the purposes of the provisions that I referred to above is being fulfilled by this series of transactions. The overall purpose as well as the use to which each individual provision was put was to make interest on money used to buy a personal residence deductible.[52]

The majority of the Supreme Court justices, in a judgment written by LeBel J with Fish, Abella, and Charron JJ concurring, agreed with the decision reached by Bowman J. However, they thought it was more accurate to say that in applying GAAR, judges should consider the result of a series of transactions as opposed to their purpose, and that only the rollover and attribution provisions[53] had been abused and not necessarily the interest deductibility provisions.

As many commentators have noted, *Lipson* appears to show a greater willingness on the part of at least the majority of the present Supreme Court of Canada justices to apply the general anti-avoidance principle. In this respect, that court might finally be adopting Bowman J's pragmatic approach to setting aside abusive transactions.

IN PRAISE OF GOING FOR THE JUGULAR

In paying tribute to Bowman J, we have claimed that he generally applied a pragmatic approach in reaching decisions in tax cases, in contrast to Supreme Court justices who have often adopted a much more formalistic approach to judicial decision making. Of course, these two terms do not identify wholly distinct methods of judging; indeed, some legal philosophers suggest that they are empty of theoretical content. Nevertheless, they identify broad differences of attitude and emphasis that ultimately relate to questions about the institutional capabilities of judges, the importance of considering the consequences of legal decisions, and the proper role of judges in a democracy. Bowman J's approach to judicial decision making reflects a thoughtful and appropriate answer to these questions. He recognized that pragmatic adjudication is unavoidable and that deciding cases involves problem-solving skills of the highest order. He did not purport to deduce answers to complex cases based on the supposed plain meaning of words or phrases. He stated goals, weighed consequences, and chose appropriate results based on notions of policy, common sense, professional values, and sensitivity to relevant tax principles. However, judicial decision making involves not just everyday cost-benefit analysis; it is also an art. In Bowman J's no-nonsense approach, mastering the art involved taking a practical approach that began with a deep understanding of how things really are but at the same time accepting

52 Ibid., at paragraph 23.

53 Sections 73 and 74.1.

responsibility for the quality of tax law. He always tried hard to reach the best results as he understood them. It is unfortunate that he did not sit on the Supreme Court, where his approach would have had more influence on the whole of the Canadian judiciary.

Most students of judicial behaviour do not explain or attempt to predict legal decisions solely on the basis of the strict application of legal concepts, no matter how derived. Instead, in explaining the motivations for judges' behaviour, they also look to the unique personal characteristics and attitudes of the individual judges and in particular their non-legal views about questions of morals and politics. Bowman J was always frank about the concerns that led him to reach his decisions, and he never pursued his personal preferences behind the veneer of legal rules. In addition to having a strong interest in the coherence and justice of tax law, he also cared deeply about the effects of the law on individual taxpayers. We will greatly miss the steady stream of his enlightened judgments.