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## A Period of Interest

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It was the best of times; it was the worst of times. The period between Donald Bowman's departure from the Department of Justice in 1971 and his appointment as judge of the Tax Court of Canada in 1991 was arguably the most interesting and the most turbulent in the Canadian tax experience.

On January 1, 1971, Canada enacted the most extensive revision of its income tax system since the enactment of The Income War Tax Act, 1917.<sup>1</sup> The revision followed extensive review, first with the theoretical pronouncements of the Carter commission,<sup>2</sup> and then by the government of the day, for whom Carter's theoretic perfection was necessarily modified by political reality and the practical discipline of power.

The objectives sought were simple: to tax hitherto untaxed capital gains; to equate equity investment with debt financing of corporations by permitting withdrawal of capital; to effect a regime that would aid small business; and to design a system to tax the foreign income of Canadian residents by preventing the tax-free accumulation of passive foreign earnings without making Canadians uncompetitive in carrying out foreign endeavours.

Although the objectives sought by the reform were simple, turning those objectives into legislation was anything but. Any such drafting would be complex, but in this case the draftsmen sought perfection or, as it was referred to at the time, the "elegant solution," as the answer to complex conceptual problems. This quest for the elegant solution led to the adoption of accounting concepts and to a great deal of specificity.

The complexity did not stop with the enactment of the revised legislation. It was found that specific and elegant solutions left specific and less than elegant holes. Every "bright line" has two sides. Holes in turn led to patchwork correction, which in turn led to more complex legislation, which in turn led to more holes. A crude

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1 SC 1917, c. 28.

2 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966).

measure demonstrates the point. In 1971, the Stikeman version of the Income Tax Act was one inch thick measured at the spine. By 1989, the end of the period that we are concerned with here, the Act measured two and one-quarter inches—and the print was smaller.

In retrospect, the pre-1971 Act was naïvely simple. There had been remarkably few recognized practitioners, and the jousting with the Canadian tax authorities was, by and large, a gentlemen's game. The effect of the complexity of the new legislation was such that the old order yielded to a completely new group of younger professionals. Within two or three years after 1971, and with one or two notable exceptions, there were no effective tax advisers left who had been over 40 at the time of enactment. This was the milieu that Donald Bowman, then aged 38, entered when he left the Department of Justice for a new career in private practice.

As discussed, the legislative changes in Canadian tax law over the two decades that are the subject of this article were extensive. The jurisprudential changes were dramatic. In 1971, Lord Tomlin's edict and the *Duke of Westminster's* writ still ran large, but by 1989, we had gone from interpreting

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to trying to glean the meaning of

a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act . . . read as a whole.<sup>4</sup>

What happened? It is my thesis that the genesis of the general anti-avoidance rule (GAAR)—the legislative reaction to the jurisprudence that evolved over the two decades—can be ascribed to two factors: the specificity of the legislation, and the 1984 decision of the Supreme Court of Canada in *Stubart Investments Limited v. The Queen*.<sup>5</sup>

Viewed 25 years after the event, the facts and the issue in *Stubart* appear benign. The objective had been to consolidate income-earning assets of one company with losses of another company, both of the same corporate family. Thus, the assets and undertaking of Stubart's profitable flavouring business were transferred to a sister company, Grover Cast Stone Company, which had incurred losses manufacturing pre-cast concrete products. Stubart carried on the flavouring business as agent for Grover, and it was understood that the assets would be transferred back to Stubart when the Grover losses had been absorbed. As the case wended its way through the lower courts, *Stubart* was of little precedential concern to observers.

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3 *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1, at 19 (HL).

4 Subsection 245(4) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended.

5 84 DTC 6305 (SCC).

Flanigan J of the Tax Review Board<sup>6</sup> found that the transaction was a sham because the parties contemplated its reversal, and that it was a transfer of the rights to income falling under section 23 of the pre-1971 Act (now subsection 56(4)). This judgment was upheld by the Federal Court Trial Division.<sup>7</sup>

The Federal Court of Appeal (Urie, Heald, and Kelly JJ concurring) also denied Stupart's appeal,<sup>8</sup> this time on the basis that the transfer of assets from Stupart to Grover had not been effectively completed. Thus, when Stupart appealed to the Supreme Court of Canada, its claim had been denied without dissent by five judges of the lower courts. That unanimity was not the end of Stupart's perceived difficulty.

Although Lord Tomlin's edict was still respected, by 1984 cracks had begun to appear in the edifice of literal interpretation of tax statutes.

The three cases *Ramsay*,<sup>9</sup> *Burmah Oil*,<sup>10</sup> and *Furniss*<sup>11</sup> ("the British trilogy") had all been decided by the House of Lords. Each case involved a series of self-cancelling transactions designed to create synthetic losses that would offset or defer real gains. Analyzing those transactions is a task that has often been dealt with and will not be further pursued here. Suffice to say, they created great concern in the tax community, because they raised many questions. Would the steps in a preordained series of transactions be severally respected? Would a commercial transaction be respected if the series included one or more steps designed to avoid or reduce taxes? And finally, would a transaction or a series of transactions be respected if it had no independent business purpose?

Like straws blew in the Canadian wind. In the *Leon* case,<sup>12</sup> one panel of the Federal Court of Appeal went a step toward incorporating a business purpose test into the Canadian experience. Heald J found:

It is the agreement or transaction in question to which the Court must look. If the agreement or transaction lacks a *bona fide* business purpose, it is a sham.<sup>13</sup>

Thus, the interposition of the management companies between the employer and the employee was a sham, pure and simple, the sole purpose of which was to avoid payment of tax.<sup>14</sup>

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6 *Stupart Investments Ltd. v. MNR*, 74 DTC 1209 (TRB).

7 *Stupart Investments Ltd. v. The Queen*, 78 DTC 6414 (FCTD).

8 *Stupart Investments Limited v. The Queen*, 81 DTC 5120 (FCA).

9 *WT Ramsay Ltd. v. IRC*, [1981] STC 174 (HL).

10 *IRC v. Burma Oil*, [1982] STC 30 (HL).

11 *Furniss v. Dawson*, [1984] STC 153 (HL).

12 *MNR v. Leon et al.*, 76 DTC 6299 (FCA).

13 *Ibid.*, at 6302.

14 *Ibid.*, at 6303.

Another panel of the Federal Court of Appeal quickly drew back from the brink. In *Massey-Ferguson Ltd. v. The Queen*, Urie J stated:

I am not at all sure that I would have agreed with the broad principles relating to a finding of sham as enunciated in that case [*Leon*], and, I think, that the principle so stated should perhaps be confined to the facts of that case.<sup>15</sup>

Given the apparent standoff in the Federal Court of Appeal, and the British trilogy, one can imagine the difficulty posed for professionals asked to advise on proposed transactions. One can also understand why the Crown decided to go all in in its appeal to the Supreme Court of Canada in *Stubart*. So emboldened, the Crown's primary argument before the court was that *Stubart's* appeal should be denied and the Grover transaction should be ignored because it lacked an independent business purpose.

Little remembered is the judgment of Wilson J. Writing for herself and Ritchie J, in four terse paragraphs she stated the *Stubart* principle, including the following reasons for rejecting a business purpose test:

I am also of the view that the business purpose test and the sham test are two distinct tests. A transaction may be effectual and not in any sense a sham (as in this case) but may have no business purpose other than the tax purpose. The question then is whether the Minister is entitled to ignore it on that ground alone. If he is, then a massive inroad is made into Lord Tomlin's dictum that "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be": *I.R.C. v. Duke of Westminster* [1936] A.C. 1 at p. 19. Indeed, it seems to me that the business purpose test is a complete rejection of Lord Tomlin's principle.

The appellant would clearly be liable to pay tax on the income from the flavourings business if the business purpose test is part of our law since it is freely admitted that the saving of tax for the Finlayson conglomerate was the sole motivation for the transaction. In my opinion, the Federal Court of Appeal in *Leon v. The Minister of National Revenue* (1976), 76 DTC 6299 characterized a transaction which had no business purpose other than the tax purpose as a sham and was in error in so doing. I do not view that case as introducing the business purpose test as a test distinct from that of sham into our law and, indeed, if it is to be so viewed, I do not think it should be followed. I think Lord Tomlin's principle is far too deeply entrenched in our tax law for the courts to reject it in the absence of clear statutory authority. No such authority has been put to us in this case.<sup>16</sup>

The judgment of Estey J, with which Beetz and McIntyre JJ concurred, arrived at the same conclusion but without the brevity. He said:

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15 77 DTC 5013, at 5020 (FCA).

16 *Supra* note 5, at 6325.

I would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or *bona fide* business purpose. A strict business purpose test in certain circumstances would run counter to the apparent legislative intent which, in the modern taxing statutes, may have a dual aspect. Income tax legislation, such as the federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no *bona fide* business purpose. Thus, by imposing a positive requirement that there be such a *bona fide* business purpose, a taxpayer might be barred from undertaking the very activity Parliament wishes to encourage. At minimum, a business purpose requirement might inhibit the taxpayer from undertaking the specified activity which Parliament has invited in order to attain economic and perhaps social policy goals. Examples of such incentives I have already enumerated.<sup>17</sup>

In arriving at his conclusion, Estey J also put paid to the *Leon* principle and to the application of the British trilogy in the Canadian experience. He concluded that in jurisdictions such as Australia and Canada, where there were specific anti-avoidance provisions in the statute,<sup>18</sup> the courts should not attempt to impose a business purpose test.

Although the lower courts' decisions in *Stubart* were treated by the tax community as of little moment, the Supreme Court's decision was viewed as a tectonic shift. If a transaction would be respected even if its sole purpose was to affect a tax result, then caution could be abandoned.

Indeed, in the four years between the Supreme Court's decision in *Stubart* and the enactment of GAAR in 1988, there was a perfect storm in tax avoidance. To the decision in *Stubart* and the specificity of legislation that created holes surrounded by bright lines, there was added a third element—economic necessity.

Up until the late 1970s and early '80s, conventional wisdom said that one could not own too much real estate or oil and gas because "they weren't making any more of it." The world turned, conventional wisdom was perceived to be fallible, and companies had millions—in some cases hundreds of millions—in losses, which, by 1984, were in danger of being stale-dated. Thus, the objective became to turn those losses to coin, and a cottage industry sprang up to satisfy that objective.

Typically, an idea would be developed to meet a specific need. However, there is no proprietary interest or secrecy in an idea. An idea conceived on Monday and put into effect on Tuesday would be common knowledge by Wednesday, and would be

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17 Ibid., at 6322.

18 The Income Tax Act of the day (SC 1970-71-72, c. 63, as amended) included section 137, which was an anti-avoidance provision of limited application.

shopped without shame or mercy by Thursday. Faced with the *Stuart* decision, neither the fisc nor the courts had the means to plug the hole.

Inevitably the government could not abide the unfairness of the synthetic transactions, the drain on the treasury, and the constant legislative amendments required to plug holes. The result was the 1988 enactment of GAAR, which, of course, has kept advisers gainfully employed during the two decades following the enactment.

All judges necessarily bring to the bench experience accumulated prior to their appointment. Donald Bowman was particularly fortunate in the baggage he had amassed.

First, in his 17 years in private practice, and the prior decade with the Crown, he had appeared before many judges in many courts. The result was to make him a counsel's judge. He let counsel run their case, interjecting to discern nuances, but not to direct the litigation.

Second, he was present at the creation and during the formative years of the legislation about which he was adjudicating. This gave him an insight that was reflected in the judgments that he wrote.