Symposium on Tax Avoidance After Canada Trustco and Mathew: Summary of Proceedings

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ABSTRACT

On October 19, 2005, the Supreme Court of Canada released its much-anticipated decisions in *The Queen v. Canada Trustco Mortgage Co.* and *Mathew v. The Queen*, the first two cases from Canada's highest court addressing the general anti-avoidance rule (GAAR) in section 245 of the federal Income Tax Act. The Faculty of Law at the University of Toronto hosted a symposium on November 18, 2005, which brought together academics, practitioners, representatives of the Canada Revenue Agency, and Chief Justice Donald Bowman of the Tax Court of Canada to discuss the implications of the decisions. This article summarizes the formal presentations and comments of participants in the proceedings.

KEYWORDS: ANTI-AVOIDANCE ■ GAAR ■ STATUTORY INTERPRETATION ■ SUPREME COURT DECISIONS ■ TAX ADMINISTRATION ■ TAX AVOIDANCE

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INTRODUCTION

On October 19, 2005, the Supreme Court of Canada released its much-anticipated decisions in *The Queen v. Canada Trustco Mortgage Co.*[1] and *Mathew v. The Queen*[2]—the first decisions in which the court has specifically considered the general anti-avoidance rule (GAAR) in section 245 of the federal Income Tax Act.[3] The GAAR was enacted in 1988 in response to the Supreme Court's decision in *Stubart Investments Limited v. The Queen*,[4] and was intended to reduce what the court had described as "the action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally-guided and equally specialized taxpayer reaction."[5] Designed "to distinguish between legitimate tax planning and abusive tax avoidance,"[6] the GAAR operates to deny a "tax benefit" that would otherwise result from an "avoidance transaction" or a "series of transactions" of which the avoidance transaction is a part,[7] provided that the transaction results in a misuse of provisions of the Act, the Income Tax

1 2005 SCC 54.

2 2005 SCC 55.

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

4 84 DTC 6305; [1984] CTC 294 (SCC). Although rejecting the traditional "strict construction" approach to the interpretation of tax statutes, the *Stubart* decision also reaffirmed the traditional approach, adopted in *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1 (HL), that tax consequences should be based on the legal character of transactions and relationships regardless of their economic or commercial substance and the absence of any non-tax purpose for their existence.

5 *Stubart*, supra note 4, at 6324; 317, cited in Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: Department of Finance, June 18, 1987), 130.

6 Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Department of Finance, June 1988), clause 186.

7 See subsection 245(2), which provides as follows: "Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction." See also subsection 245(5), which sets out various ways in which the tax consequences to a person may be determined in order to deny a tax benefit that would otherwise result from an avoidance transaction.

Regulations, the Income Tax Application Rules, a tax treaty, or any other relevant enactment, or is an abuse having regard to those provisions read as a whole.[8]

On November 18, 2005, the Faculty of Law at the University of Toronto hosted a symposium on the Supreme Court of Canada's decisions in *Canada Trustco* and *Mathew*, the purpose of which was to review the judgments and consider their implications for tax avoidance in Canada. Participants included academics, practitioners, representatives of the Canada Revenue Agency (CRA), and Chief Justice Donald Bowman of the Tax Court of Canada. The symposium was broadcast live on the Web and for a limited time can be viewed, together with the papers and presentations prepared for the symposium, at http://www.law.utoronto.ca/conferences/taxavoidance.html.

The first session reviewed these landmark decisions. Presentations were made by Professor David G. Duff (Faculty of Law, University of Toronto), Professor Jinyan Li (Osgoode Hall Law School), Professor Daniel Sandler (Faculty of Law, University of Western Ontario), and Professor Benjamin Alarie (Faculty of Law, University of Toronto); comments were made by Alexandra Brown of the Department of Justice (who appeared as counsel for the Crown in *Canada Trustco* and *Mathew*) and Al Meghji of Osler Hoskin & Harcourt LLP (who argued the case for the taxpayer in *Canada Trustco*). The session was chaired by Roger Taylor (Couzin Taylor LLP/Ernst & Young LP), and ended with questions posed by the chair and the audience.

The second session considered the implications of the decisions for tax avoidance in Canada. Chaired by Scott Wilkie of Osler Hoskin & Harcourt LLP, who began with introductory remarks, the session included comments by Wayne Adams (director general of the CRA's Rulings Directorate and current chair of the GAAR Committee), Sharon Gulliver (head of the GAAR Section of the CRA's Tax Avoidance Division), Robert Couzin (Couzin Taylor LLP/Ernst & Young LP), and David Smith (Davies Ward Phillips & Vineberg LLP), followed by a round table discussion of different tax-avoidance scenarios, including the *Duke of Westminster* case[9] and current cases under consideration by the CRA.

The symposium ended with final comments by Bowman CJ.

This paper summarizes the presentations and comments made at the symposium.

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8 Subsection 245(4). As originally enacted, this provision stipulated that the GAAR would not apply to a transaction "where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole." Subsection 245(4) was amended in 2005, with retroactive application to the date when the GAAR came into effect, by specifying that the GAAR would apply to a misuse or abuse of the Income Tax Regulations, the Income Tax Application Rules, a tax treaty, or any other relevant enactment, as well as the Act, and by converting the double negative language of the original provision to a positive test stipulating that the GAAR "applies to a transaction only if it may reasonably be considered that the transaction . . . would . . . result . . . in a misuse . . . or . . . abuse."

9 Supra note 4.

FIRST SESSION: CANADA TRUSTCO, MATHEW, AND THE GAAR

Professor David G. Duff

The first session began with a critical review of the cases by Professor David G. Duff. After briefly summarizing the facts and specific decisions in each case, Professor Duff reviewed the court's conclusions with respect to statutory interpretation, the relationship between tax avoidance and the GAAR, and the various tests that must be met for the GAAR to apply.

In the *Canada Trustco* decision, the court reached three specific conclusions. First, the leveraged sale-leaseback arrangement entered into by the taxpayer did not contradict the object, spirit, or purpose of the capital cost allowance (CCA) regime, taking into account the leasing property and specified leasing property rules. Second, there is no general policy in the Act that "cost" means real economic cost or amounts economically at risk. Third, there is no general economic substance test that can be used to determine whether transactions are subject to the GAAR.

In *Mathew*, on the other hand, the court concluded that the various transactions (the transfer of mortgages with accrued losses to a partnership, the acquisition of interests in the partnership by arm's-length investors, and the deduction of those losses by the investors when realized by the partnership) contradicted a general policy of the Act to prohibit the transfer of losses between taxpayers (subject to specific exceptions), as well as the object, spirit, and purpose of subsection 18(13) to disallow superficial losses on transfers of property that remain in the transferor's control and of subsection 96(1) "to promote an organizational structure that allows partners to carry on a business in common, in a non-arm's length relationship."[10] Professor Duff agreed with the outcome in *Mathew*, but called into question the conclusions in *Canada Trustco* and the court's interpretation of subsection 96(1) in *Mathew*.

Turning to the court's views on statutory interpretation, Professor Duff noted that the court's repeated references to "textual, contextual and purposive" interpretation must be balanced against its somewhat less frequent references to "consistency, predictability and fairness." Although the court commented that the detailed nature of specific provisions in the Act generally supports a greater emphasis on the text of these provisions than on their context or purpose,[11] it also observed that "statutory context and purpose may reveal or resolve latent ambiguities" in an otherwise apparently unambiguous text.[12] For this reason, Professor Duff concluded that the court had abandoned the "plain meaning" approach that had dominated its tax judgments since the mid-1990s.

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10 *Mathew*, supra note 2, at paragraph 52.

11 *Canada Trustco*, supra note 1, at paragraphs 11 and 13.

12 Ibid., at paragraph 47, citing Peter W. Hogg, Joanne E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*, 4th ed. (Toronto: Carswell, 2002), 563.

With respect to the relationship between tax avoidance and the GAAR, the court stated that the old *Duke of Westminster* principle that taxpayers may manage their affairs to minimize tax endures, but it must be balanced against the GAAR, which has been "superimposed" or "engrafted" onto this traditional approach.[13] According to the court, the GAAR does not prohibit efforts to minimize tax, but draws "a line between legitimate tax minimization and abusive tax avoidance."[14] As a result, the court concluded, its task is to unite the *Duke of Westminster* principle with the GAAR,[15] reflecting Parliament's purpose to preserve predictability, consistency, and fairness in Canadian tax law.[16] Professor Duff considered this approach to be reasonable and consistent with legislative intentions and the structure of the GAAR.

With respect to the GAAR itself, the court focused mainly on the misuse or abuse requirement in subsection 245(4), but it also considered the requirement that the transaction or series of transactions result in a tax benefit, and the exclusion in subsection 245(3) for transactions that "may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit." On the concept of a tax benefit, the court emphasized that it was a factual determination with which appellate courts should not interfere "absent a palpable and overriding error,"[17] adding that the existence of a tax benefit might be "established by comparison with an alternative arrangement,"[18] and that "the existence of a tax benefit is clear, since a deduction results in a reduction of tax."[19] While Professor Duff agreed that the characterization of a tax benefit is a factual determination for which it was generally necessary to consider an alternative "benchmark" arrangement, he questioned whether a deduction should necessarily be characterized as a tax benefit, preferring the view of Miller J in *Canada Trustco* that the existence of a tax benefit should be determined "in the context of . . . whether there is an avoidance transaction."[20]

On the concept of a series of transactions, which enters into the definition of an avoidance transaction in subsection 245(3), the court adopted a narrow interpretation of the ordinary meaning of these words to include only transactions that are "pre-ordained in order to produce a given result" with "no practical likelihood that the pre-planned events would not take place in the order ordained."[21] On the

13 *Canada Trustco*, supra note 1, at paragraphs 1 and 13.

14 Ibid., at paragraph 16.

15 Ibid., at paragraph 1.

16 Ibid., at paragraph 31.

17 Ibid., at paragraphs 19 and 66 (subparagraph 7).

18 Ibid., at paragraph 20.

19 Ibid.

20 *Canada Trustco Mortgage Company v. The Queen*, 2003 DTC 587; [2003] 4 CTC 2009, at paragraph 52 (TCC).

21 *Canada Trustco*, supra note 1, at paragraph 25, citing *Craven v. White*, [1989] AC 398, at 514 (HL), per Lord Oliver.

extended definition of this phrase in subsection 248(10), which includes "related transactions or events completed in contemplation of the series," the court held that "related" transactions can occur before or after the ordinary series,[22] and that transactions completed "in contemplation of" a series do not require "actual knowledge" (as a majority of the Federal Court of Appeal had concluded in *OSFC Holdings Ltd. v. The Queen*)[23] but occur "because of" or "in relation to" the series.[24] Although Professor Duff agreed with the court's understanding of the ordinary meaning of "a series of transactions," on the grounds that it was consistent with legislative intent when the GAAR was enacted and with the existence of the extended definition in subsection 248(10), he questioned the court's interpretation of the extended definition on the basis that it seemed incompatible with the text of subsection 248(10).

Turning to the non-tax purpose test in subsection 245(3), the court held that it also is a factual determination, that the nature of this determination is objective and relative, that the threshold for this determination is neither high nor low, and that it "will not suffice" for this purpose to show that an alternative transaction would have resulted in higher taxes.[25] While agreeing with the court's conclusions that this test involves a factual determination based on objective and relative considerations, Professor Duff suggested that the text of subsection 245(3) favours a relatively low threshold whereby the taxpayer must simply advance a reasonable case that the transaction was undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. He also noted that the existence of a higher-taxed alternative may be relevant to the characterization of an avoidance transaction notwithstanding the court's conclusion that this alone is not sufficient, adding that this reference to an alternative or benchmark transaction does not involve a "recharacterization" of the transaction.

With respect to the misuse or abuse test in subsection 245(4), the court made five general points. First, instead of two separate inquiries into the misuse of specific provisions and the abuse of the provisions of the Act read as a whole, this provision "requires a single, unified approach to the textual, contextual and purposive interpretation of the specific provisions of the *Income Tax Act* that are relied upon by the taxpayer in order to determine whether there was abusive tax avoidance."[26] Second, the test in subsection 245(4) involves a two-step inquiry: (1) a legal inquiry to determine the "object, spirit and purpose" of "the provisions giving rise to the tax benefit," and (2) a factual inquiry to "determine whether the avoidance transaction

22 *Canada Trustco*, supra note 1, at paragraph 26.

23 2001 DTC 5471; [2001] 4 CTC 82, at paragraph 36 (FCA): parties to the related transaction must "know of" the ordinary series of transactions "such that it could be said that they took it into account when deciding to complete the transaction."

24 *Canada Trustco*, supra note 1, at paragraph 26.

25 Ibid., at paragraphs 28-30.

26 Ibid., at paragraph 43.

defeated or frustrated the object, spirit or purpose of the provisions in issue."[27] Third, the abusive nature of an avoidance transaction must be clear for the GAAR to apply, with doubts resolved in favour of the taxpayer.[28] Fourth, it is for the minister "to identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated."[29] Fifth, while a lack of economic substance may be relevant to the characterization of an abusive transaction where the object, spirit, or purpose of specific provisions limits tax benefits to transactions with economic substance,[30] an absence of economic substance alone does not make an avoidance transaction abusive within the meaning of subsection 245(4).

Professor Duff considered the court's two-step approach to the application of subsection 245(4) to be workable, but he questioned its combination of the misuse and abuse tests into a "single, unified approach," its determination that a misuse or abuse must be clear with doubts resolved in favour of the taxpayer, and its conclusion that economic substance has no role to play absent specific provisions that limit tax benefits to transactions with economic substance. Beginning with the "single, unified approach," he observed, the court's interpretation contradicts the text of subsection 245(4), which refers to a misuse of specific provisions and an abuse having regard to these provisions read as a whole, and precludes a broader abuse analysis by emphasizing the specific provisions on which the taxpayer has relied to obtain the tax benefit. To the extent that the Act is "intended to apply to transactions with real economic substance,"[31] he added, transactions lacking any economic substance might reasonably be regarded as an abuse having regard to the provisions of the Act read as a whole. Finally, he suggested, while the court's conclusion that a misuse or abuse must be clear is consistent with the double negative language in subsection 245(4) as it formerly read, the amended version suggests that the GAAR should apply where it is reasonable to conclude that the transaction results in a misuse or abuse, notwithstanding that a reasonable argument might also be made that the transaction is not abusive. In other words, doubts should now be resolved in favour of the Crown.

Professor Jinyan Li

Professor Li's presentation addressed the concept of economic substance. Professor Li asked whether the economic substance doctrine is relevant to the application of the GAAR, what the doctrine means, what the doctrine's proper role might be under subsection 245(4), how economic substance is determined, and what implications the *Canada Trustco* and *Mathew* decisions have for the doctrine in Canada.

27 Ibid., at paragraphs 44 and 55.

28 Ibid., at paragraphs 50 and 69

29 Ibid., at paragraph 65.

30 Ibid., at paragraph 58.

31 Supra note 6, at clause 186, cited in *Canada Trustco*, supra note 1, at paragraph 48.

Professor Li suggested that the economic substance doctrine is relevant to the application of the GAAR, given the statement in the explanatory notes accompanying draft legislation for the GAAR:

> Subsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the Act to avoid tax.[32]

In *Canada Trustco*, however, the court adopted a narrow view of economic substance, concluding that it had no relevance absent specific provisions that made it relevant to the availability of a tax benefit. In *Mathew*, on the other hand, economic substance may have played a role in the background, since the court considered factors that are relied upon in other countries to determine economic substance.

On the meaning of the economic substance doctrine, Professor Li considered three alternatives. According to the US doctrine derived from Judge Learned Hand's judgment in *Helvering v. Gregory*,[33] transactions are assessed according to their real economic substance. According to the Canadian substance-over-form doctrine, transactions are assessed on the basis of their legal substance regardless of the nomenclature that the parties use to describe the transactions.[34] According to the step transaction doctrine adopted by the House of Lords in a series of cases,[35] transactions lacking a business purpose that are part of a series of transactions will be disregarded for tax purposes. According to Professor Li, it was the first of these doctrines that the drafters had in mind when the GAAR was enacted.

Turning to the role of economic substance in the application of subsection 245(4), Professor Li argued that its relevance followed from a textual, contextual, and purposive analysis of the provision. Textually, she explained, the requirement that the avoidance "results" in a misuse or abuse suggests an inquiry into the economic substance of the transaction rather than its legal form. Contextually, the history of the GAAR, which was enacted in response to the Supreme Court of Canada's decision in *Stubart Investments*,[36] suggests a deliberate policy to introduce a broader concept of economic substance. Finally, Professor Li observed, the explanatory notes made it clear that subsection 245(4) was intended to rely on the concept of economic substance to distinguish between legitimate tax planning and abusive tax avoidance. As a result, transactions lacking economic substance should be presumed to frustrate the legislative purpose of the Act, unless the transactions

32 Supra note 6, at clause 186.

33 69 F. 2d 809 (2d Cir. 1934).

34 See, for example, *Duke of Westminster*, supra note 4.

35 See, for example, *W. T. Ramsay Ltd. v. IRC*, [1981] 1 All ER 865 (HL); *Commissioners of Inland Revenue v. Burmah Oil Co. Ltd.* (1981), 54 TC 200 (HL); *Furniss v. Dawson*, [1984] AC 474 (HL); and *Craven v. White*, supra note 21.

36 Supra note 4.

are clearly supported by the text, context, and purpose of specific provisions or the Act read as a whole.

On the determination of economic substance, Professor Li found limited guidance in *Canada Trustco* and *Mathew* but considerable value in tax cases and anti-avoidance rules in other countries. In the United States, for example, the District Court for Connecticut relied on the economic substance doctrine to disregard the transactions in *Long-Term Capital Holdings v. United States*[37]—a case that, like *Mathew*, involved the transfer of accrued losses through the use of a partnership. Of particular relevance in the *Long-Term Capital Holdings* case was the conclusion that no prudent investor would have acquired the partnership interests but for the tax benefit available through the tax losses. In *Frank Lyon Co. v. United States*,[38] on the other hand, the US Supreme Court concluded that a sale-leaseback of a building had economic substance on the basis that the lessee was not allowed to own the building for regulatory reasons and that the rent charged by the lessor was a market rate. Professor Li noted, however, that the sale-leaseback in *Frank Lyon Co.* had more economic substance than the transactions in *Canada Trustco*.

Finally, Professor Li concluded, the decisions in *Canada Trustco* and *Mathew* have done little to clarify the role of the economic substance doctrine. As a result, she suggested, more guidance is needed.

Professor Daniel Sandler

Professor Sandler considered the minister's burden under the GAAR, devoting particular attention to subsection 245(4) and the Supreme Court of Canada's conclusion in *Canada Trustco* that the minister should bear the burden of demonstrating that the avoidance transaction at issue resulted in a misuse or abuse within the meaning of this provision. As an initial matter, however, Professor Sandler considered the burdens that the taxpayer and the minister face under the first two requirements for the GAAR to apply: that the transaction or series of transactions must have resulted in a tax benefit, and that the transaction cannot reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

With respect to the first and second GAAR requirements, Professor Sandler began by noting that the *Canada Trustco* decision placed the burden in each case on the taxpayer to disprove the assumptions of fact on which the minister's assessment was based.[39] While Professor Sandler did not question these conclusions, he suggested that the minister should bear a prior burden regarding the kinds of cases that it should pursue under the GAAR. He identified three paradigmatic types of tax avoidance: substitutable transactions (where a taxpayer has a valid non-tax objective but pursues this objective through a tax-advantageous route); the trading of tax

37 330 F. Supp. 2d 122 (D. Conn. 2004).

38 435 US 561 (1978).

39 *Canada Trustco*, supra note 1, at paragraph 63.

attributes (as in *Canada Trustco* and *Mathew*); and the fabrication of tax attributes (for example, art flips). According to Professor Sandler, unless the taxpayer's transactions clearly involve one of these paradigmatic types of tax avoidance, the CRA should not pursue the issue under the GAAR.

Turning to the minister's burden under subsection 245(4), Professor Sandler observed that the court's two-step inquiry makes it difficult to determine precisely what the minister's burden is. The first inquiry into the object, spirit, and purpose of the relevant provisions is a question of law, he suggested, and it is therefore a question for the court to determine, not for the parties to prove. As a result, it follows that any burden of proof imposed on the minister must relate to the second, primarily factual, inquiry: whether the transaction at issue frustrates or defeats the object, spirit, or purpose of the relevant provisions. At the same time, Professor Sandler acknowledged that the minister presumably bears a practical burden to advance some argument about the object, spirit, and purpose of the provisions at issue in order to support the assessment. Nonetheless, he was skeptical about the court's suggestion in this regard that "[t]he Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue."[40]

As a final matter, Professor Sandler addressed the standard that should be applied in determining the object, spirit, and purpose of provisions of the Act, asking whether this must be "clear and unambiguous," as a majority of the Federal Court of Appeal held in *OSFC Holdings Ltd.*;[41] "clear," as the Supreme Court of Canada suggested in *Canada Trustco*;[42] or "the most reasonable." Since this issue is a question of law that the court must determine, he suggested that the last of these standards should apply.

In any event, Professor Sandler concluded, a tax judge's determination of or failure to determine the object, spirit, and purpose must always be open to review by an appellate court. As a question of law, any error in this respect need not be "palpable and overriding" to be overturned on appeal.

Professor Benjamin Alarie

Professor Alarie's presentation addressed the retroactive amendment of subsection 245(4), which (1) extended the application of the GAAR to the Income Tax Regulations, the Income Tax Application Rules, tax treaties, and other relevant enactments, and (2) replaced the double negative language that the GAAR does not apply where it may reasonably be considered that the transaction does not result in a misuse or abuse with a positive test that the GAAR does apply where it may reasonably be considered that the transaction results in a misuse or abuse. Assuming

40 Ibid., at paragraph 65.

41 Supra note 23, at paragraph 69.

42 *Canada Trustco*, supra note 1, at paragraph 50.

that these amendments have substantive implications by extending the scope of the GAAR and lowering the threshold for determining the existence of a misuse or abuse, Professor Alarie began by addressing the Supreme Court of Canada's statement in *Canada Trustco* that the amendment "has no application to the judgments under appeal" because "it cannot apply at this stage of appellate review, after the parties argued their cases and the Tax Court judge rendered his decision on the basis of the GAAR as it read prior to the amendment."[43] More specifically, he considered what, if any, legal obstacles there might be to retroactive legislation, the consequences of retroactive legislation for pending proceedings, and the general policy implications of retroactive legislation.

With respect to legal obstacles to retroactive legislation, Professor Alarie began by noting that most legal systems consider such legislation to be unfair and appropriately limited through legal means. In Canada, for example, the Charter of Rights and Freedoms prohibits retroactive legislation where liberty interests are at stake.[44] More generally, courts have long held that retroactive legislation should be interpreted strictly in order to limit its scope.[45] Absent constitutional prohibitions, however, the Supreme Court of Canada held as recently as September 2005 that "there is no requirement of legislative prospectivity embodied in the rule of law or in any provision of our Constitution."[46] As a result, it seems, there are few if any legal obstacles to retroactive tax legislation.

With respect to pending proceedings, Professor Alarie cited conflicting case law, suggesting on the one hand that retroactive legislation must be explicitly drafted in order to interfere with pending proceedings,[47] and on the other hand that "the legislator need not refer specifically to pending actions in order for retroactive legislation to affect the rights of litigants."[48] Given these conflicting opinions, he considered it unfortunate that the Supreme Court of Canada did not address the issue more carefully in *Canada Trustco*. Nonetheless, he concluded, the case law makes it clear that Parliament can resolve any doubt in this regard by making retroactive amendments specifically applicable to pending proceedings.

As a final matter, Professor Alarie addressed the policy implications of retroactive legislation. After briefly reviewing differing theoretical perspectives on the merits of compensation or grandfathering provisions when tax laws change, he suggested that there was little reason to grandfather amendments designed to

43 Ibid., at paragraph 7.

44 See, in particular, section 11(g) of the Canadian Charter of Rights and Freedoms, part I of the Constitution Act, 1982, being schedule B of the Canada Act 1982 (UK), 1982, c. 11.

45 See, for example, *Kent v. The King*, [1924] SCR 388.

46 *British Columbia v. Imperial Tobacco Canada Ltd.*, 2005 SCC 49, at paragraph 69, per Major J.

47 *Hornby Island Trust Committee v. Stormwell* (1988), 53 DLR (4th) 435 (BCCA).

48 *CI Mutual Funds Inc. et al. v. The Queen* (1997), 5 GTC 1189, at 1199 (TCC), per Rip J; aff'd. [1999] 2 FC 613 (FCA).

make the GAAR more effective, and that a good case could be made for retroactive amendments designed to improve the effectiveness of the GAAR in preventing abusive tax avoidance. In this respect, he suggested, policy makers should consider, and taxpayers and their advisers should anticipate, the introduction of a GAAR penalty to deter abusive tax-avoidance transactions.

Alexandra Brown

Alexandra Brown commented on the effect of these cases in two main areas: (1) statutory interpretation of the Income Tax Act generally, and (2) statutory interpretation in the context of the GAAR. Addressing first the Supreme Court of Canada's statement that the correct approach to statutory interpretation of the Act generally is the "textual, contextual and purposive" approach, Ms. Brown suggested that (unfortunately from the perspective of someone acting as counsel for the Crown) the tendency to apply the plain meaning rule has probably not been abandoned. Past decisions of the court have advocated seemingly broad approaches to statutory interpretation and then have been sharply qualified. In *Shell Canada Ltd. v. The Queen*,[49] for example, before her frequently quoted statement regarding the pre-eminence of "*bona fide* legal relationships" over economic substance,[50] McLachlin J (as she then was) stated that "[t]his Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form."[51] Similarly, Ms. Brown suggested that despite the repetition of the phrase "textual, contextual and purposive approach" in *Canada Trustco* and *Mathew*, courts in future cases may focus on the qualifications to this approach rather than on statements of the general principle.

With regard to what should be taken from the court's handling of the GAAR specifically, Ms. Brown explained that the final outcomes in the cases were largely anticipated by those closely involved in the litigation. Much of the discussion of the GAAR in *Canada Trustco* is devoted to subsection 245(4). Ms. Brown suggested that it will probably now be easier for the Crown to successfully defend GAAR assessments in certain cases. However, the range of cases in which a GAAR assessment can successfully be defended has perhaps been narrowed because of the need to root the GAAR analysis in the legislative purpose of particular statutory provisions. In her view, taxpayers are vulnerable under the GAAR now only to the extent that it can be argued that a transaction has defeated a particular statutory purpose. In this respect, Ms. Brown argued, the court had conflated the two tests of subsection 245(4), leaving out the language referring to "the Act read as a whole." In her view, this may not be of great practical significance: to consider each specific provision in its context, the court must inevitably refer to the Act as a whole.

49 [1999] 3 SCR 622.

50 Ibid., at paragraph 39.

51 Ibid.

Nevertheless, the possibility remains that the court's focus on interpretation of specific provisions in the Act will make it more difficult to apply the GAAR.

In the Supreme Court of Canada, the Crown argued that the Act contemplates that transactions are required to have economic substance in order to withstand a GAAR attack. The hope was that the court would adopt this broadly based requirement for economic substance. However, the Crown also focused on a narrower argument—namely, that the provisions that make up the CCA scheme specifically require economic substance. Neither proposition was accepted by the court.

Ms. Brown made two points in closing. First, in her view, the court has indicated clearly that it has no wish to hear more cases involving the GAAR in the near future. The court emphasized that decisions in GAAR cases are very much driven by findings of fact (which are difficult to overturn on appeal) and directly endorsed the reasoning of the Tax Court judge in each case. Second, the analysis in *Canada Trustco* closely resembles the analysis undertaken by the House of Lords in *Barclays Mercantile Business Finance Ltd. v. HM Inspector of Taxes*,[52] suggesting that the court may well have consulted the UK decision when preparing its reasons. Thus, Ms. Brown submitted, the House of Lords may still be persuasive authority at the Supreme Court of Canada.

Al Meghji

Al Meghji's comments were directed primarily at the role of economic substance in GAAR litigation. He explained that as a starting point the best way to make sense of how the courts, including the Supreme Court of Canada, have handled economic substance arguments is to recognize two of the institutional constraints within which courts work. First, commercial certainty is a public policy virtue that the courts seek to protect. Courts are made uncomfortable by the possibility that administrative agencies will have a broad discretion to discern economic substance and apply anti-avoidance rules subjectively, since this will interfere with commercial certainty and mean that similarly situated taxpayers will not necessarily be treated similarly. Second, courts are concerned about being seen as doing things that are legitimate from a judge's point of view. This is especially clear from the judgments of the Supreme Court of Canada in tax cases over the last 15 years. The court would like dispassionate people to be able to agree that its decisions are based on sound legal principles.

Mr. Meghji then spoke more directly about the problems with the idea of economic substance. First, he suggested, the Crown has not articulated how the requirement of economic substance works in a way that respects judicial legitimacy and commercial certainty. Until the Crown can do this, it will not be successful. Second, is the economic substance requirement a rule of interpretation or an anti-avoidance device? The state will use economic substance as an anti-avoidance

52 [2004] UKHL 51.

measure only when it is first satisfied that it does not like a transaction for other reasons. This practice is illegitimate if it means that economic substance is being applied selectively to some taxpayers and not to others. Economic substance needs clear theoretical underpinnings. Finally, Mr. Meghji argued that for the most part the Act is a system that bases tax on legal relationships, not on economic substance. He cited as an example the distinction made in the Act between employees and independent contractors. Even though these relationships are economically quite similar, they are legally dissimilar and have very different tax consequences as a result. The Act is by and large structured on legal form; it is not intended to apply only to the underlying economic substance of transactions.

Mr. Meghji concluded with two short observations. First, he argued that putting the burden on the minister to establish the object or spirit of a provision is entirely in keeping with common sense. A taxpayer should be able to pick up the Act, read it, and assume that the words reflect the object and spirit of the Act and Parliament's policy choices. Taxpayers should not first have to look behind the words for some other meaning. If the state wants to be able to step in and interfere with the application of the words of the Act, then the state should be able to articulate in a meaningful way why it is necessary to do so. Second, he pointed out that the major lesson from the two GAAR judgments for practitioners, planners, and taxpayers is, "God help you if you lose at the Tax Court."

Questions

The first question concerned the consequences of the application by the court of the old language of subsection 245(4). More specifically, since the old language had been interpreted and applied by the court, would it be correct to say that the Supreme Court's reasoning would apply only to cases that had already been heard at the trial level? Professor Duff responded that to the extent that there is a principle about new provisions not applying retroactively, the answer would depend on what stage the proceedings were at. For any cases that had not yet gone to the Tax Court, the new language would apply.

A supplementary question was whether, prospectively, there will be any difference in the emphasis on the Crown's onus to show clearly that the transaction is abusive. Professor Sandler stated that the Supreme Court's judgments suggest that the first step is to interpret and determine the legislative purpose of the provision. He referred to the judgment in *Hill v. The Queen*,[53] in which, because the purpose of the provision was not manifest, Miller J held that the taxpayer should prevail. In view of the approach advocated by the court in the two GAAR decisions, Professor Sandler thought that the courts cannot now take the same approach that Miller J took in *Hill*.

53 2002 DTC 1749 (TCC).

The next question was whether the GAAR has a smaller role to play in light of the textual, contextual, purposive approach to statutory interpretation espoused by the court in *Canada Trustco* and *Mathew*. Professor Sandler responded that if the court was serious about every provision being read in a textual, contextual, purposive way, then arguably we do not need the GAAR. On the basis of tax-avoidance cases following *Stubart*, however, he predicted that we may get a textual, contextual, purposive approach to statutory interpretation only in GAAR cases. Ms. Brown reiterated her earlier point that the "textual, contextual and purposive" language is qualified significantly, noting that the court states only that the guiding principles from the *Duke of Westminster* and the plain meaning approach "may be attenuated" by the GAAR.

The next question was whether a GAAR penalty is something to be advocated as a deterrent to abusive tax avoidance. Professor Alarie responded that, from an efficiency perspective, society is better off without abusive tax avoidance, since it diverts significant amounts of human and financial capital from productive uses. To the extent that a retroactive GAAR penalty is a card that Parliament can play—and the case law suggests that it is—then all tax planners, advisers, and taxpayers should consider this possibility before engaging in what might be characterized as abusive tax avoidance.

The next question focused on GAAR cases in which conflicting schemes in the Act may be in play. What should the courts do when they are confronted with this type of conflict in the purposes of provisions? Professor Sandler responded that Professor Duff would say that any doubt should now be resolved in favour of the Crown. He said that he could not give a definitive answer, since he was not sure what the Supreme Court of Canada would say.

Another question was whether the court was right to state that the retroactive amendment to subsection 245(4) would not have resulted in a different approach. Professor Duff responded that while the court was aware of the amendment, it did not appreciate the effect of eliminating the double negative language. Professor Sandler rhetorically asked how many people in the audience were even aware of the elimination of the double negative in subsection 245(4).

It was next suggested that Professor Duff's arguments about a scheme of the Act against loss trading could be challenged by an equally tenable argument that there are specific words against loss trading used in specific contexts, and specific contexts in which Parliament has chosen not to use a similar approach. Professor Duff responded that there is a need to consider changes to the Act over time, and that a statutory scheme may evolve as specific rules are introduced to respond to cases with which Parliament disagrees. If there was no scheme until general rules were enacted to address all cases, there would be no need for the GAAR.

The last question concerned the concept of economic substance: was the court right to conclude that the concept has no relevance absent a specific statutory provision that makes it relevant? Professor Li agreed that this is exactly what the court said, but she disagreed with it as the correct approach to the GAAR on the basis that it was too narrow.

SECOND SESSION: IMPLICATIONS FOR TAX AVOIDANCE

Introductory Remarks by Scott Wilkie

Scott Wilkie began the second session by stating that the session's purpose was to consider the views of the government and the private sector on the Supreme Court of Canada's decisions. After introducing the speakers, he emphasized that practitioners and administrators have to deal with the GAAR in opinion practice in deciding how the law ought to be administered. In so doing, he suggested, it is important to disengage one's perceptions of fiscal morality and motivation and determine as rigorously as possible when transactions, events, or arrangements do or do not fit within what Parliament must have intended when it enacted a particular provision. Concepts of economic substance and economic reality raise difficult questions about how to react to planning ideas, tax planning, and financial product planning. These involve difficult judgments on the part of the Crown, taxpayers, and their advisers.

Sharon Gulliver

The decisions rendered were what the CRA expected—a win in *Mathew* and a loss in *Canada Trustco*. On the basis of some remarks made by the panel at the Supreme Court of Canada hearing, the CRA had anticipated a dissent in *Canada Trustco*. While that did not happen, it appears that dissenting comments may have been incorporated in the decision. However, it is evident that the application of the GAAR remains as debatable as ever.

Ms. Gulliver then commented on each stage of the GAAR analysis. The Supreme Court stated that the magnitude of the tax benefit is not relevant. The court recognized that in some cases the tax benefit would be clear and in other cases a benchmark might be required. Ms. Gulliver would have thought that in all of the GAAR cases the tax benefit would be the least difficult component to identify. However, a few days after the Supreme Court decisions, a Tax Court GAAR decision, *Univar Canada Ltd. v. The Queen*,[54] was released. In that case, Bell J determined that there was no tax benefit in the series of transactions. Ms. Gulliver stated that the CRA is troubled by Bell J's not finding a tax benefit in *Univar*.

Ms. Gulliver then discussed the determination of an avoidance transaction. The burden rests with the taxpayer to show that the transaction is primarily for a non-tax purpose. That said, however, the CRA recognizes that it has a responsibility to refute whatever is presented as the non-tax purpose. This means that the CRA's auditors must continue to do the things they have done in the past—perhaps even more vigilantly, where feasible, since the Supreme Court has emphasized that Tax Court decisions should not be disturbed absent a palpable and overriding error. The CRA wants to ensure that it has the documentary evidence that may refute any

54 2005 TCC 723.

oral testimony, because the weight of oral testimony versus documentary evidence will be a deciding factor with respect to establishing an avoidance transaction.

The CRA has lost two tax court decisions in which the oral testimony prevailed over the documentary evidence in determining whether there was an avoidance transaction. One case was *Husky Oil Limited v. The Queen*;[55] the other is the recent *Univar* decision. Ms. Gulliver said that she respected the message that the Supreme Court of Canada is sending to the Court of Appeal. The onus will be on the CRA to ensure that its audit is complete in all aspects and to be fully prepared to assist the Department of Justice lawyers with the recognized difficult task of upholding the application of the GAAR in the Tax Court.

With respect to the question of misuse and abuse, the Supreme Court's decisions confirm that the burden of proof rests with the CRA. Ms. Gulliver stated that the CRA has always recognized that it must establish the abuse within the scheme of the Act—a primary reason for the existence of the GAAR Committee. She noted that the CRA has learned from the GAAR decisions rendered to date, and that the inventory of GAAR cases has declined significantly from the earlier years of the GAAR (disregarding the GAAR being added as a position in issues involving mass-marketed structures such as the cash-leverage donation arrangement, RRSP strips, and non-resident spousal trusts).

Ms. Gulliver indicated that she found paragraphs 44 and 45 of the *Canada Trustco* decision significant because they provide direction to the CRA on how the misuse and abuse analysis is to be applied. The Supreme Court stated that abusive tax avoidance will occur when the transaction defeats the underlying rationale of the provisions that are relied upon. The court further stated that an abuse may be found in an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, purpose, and spirit of those provisions. Paragraphs 44 and 45 will provide the CRA with considerable guidance in determining whether it has met its burden with respect to establishing an abuse.

At present, the CRA does not propose any amendments to the GAAR provisions. It will wait to see how the Tax Court interprets the Supreme Court's decisions. The GAAR Committee will continue to exist. Cases in the CRA's current GAAR inventory include non-resident trust issues; stock dividends creating capital losses; donation arrangements, including cash-leveraged arrangements that are also challenged as sham transactions; tower structures involving the importation of interest expense; duplication of exempt surplus; dividend strips; avoidance of section 80; and provincial tax-avoidance issues for which the CRA has to consider a provincial GAAR.

Issues currently before the Tax Court include indirect loan cases similar to *Univar* (there are at least three other cases) and treaty-shopping cases. For example, the case of *MIL Investments Ltd.* involves a corporate taxpayer continuing from a non-treaty country to a treaty country in order to benefit from a treaty exemption.

55 99 DTC 308; [1999] 4 CTC 2691 (TCC).

Another case before the Tax Court concerns the utilization of subsection 47(1), the identical-property rule, to achieve income splitting. The CRA is awaiting a decision on a rollover to a spouse involving subsection 73(1), where a series of transactions leads to a result similar to that in *Singleton*[56] (tax planning to generate a deductible interest expense versus a personal interest expense).

Wayne Adams

Wayne Adams stated that the structure in *Canada Trustco* was accepted by the court as more in the nature of a business decision than an abusive tax-avoidance scheme. There are elements in this type of structure that the CRA would continue to examine, such as an accommodating arm's-length party, outside financing (which, in Mr. Adams's opinion, puffs up the value of the transaction), and the fact that the borrowed funds were immediately returned to the outside lender. The outcome of *Canada Trustco* is that Len Farber and his team will likely recommend an amendment to the specified leasing property rules to address the concerns identified by the Crown.

The CRA will continue to screen cases. Mr. Adams would be concerned if an objective audience looked at a set of transactions and could not see why the transactions were challenged. The CRA accepts that GAAR cases are difficult to win, but he receives feedback from a broad constituency suggesting that the structures need to be challenged.

In the early GAAR years, Mr. Adams noted, five typical GAAR structures were challenged, albeit unsuccessfully, by the CRA:

1. weak currency loans;
2. indirect loans (subsections 15(2) and 214(3)) (*Univar*);
3. section 80 debt-parking arrangements;
4. charitable loanbacks to closely related foundations; and
5. premium-priced debt.

Each of these cases, however, led to legislative changes to address the tax results under scrutiny. Mr. Adams believes that a thread of an economic substance argument is present in the case law, although judges sometimes do not refer to it explicitly. He also stated that the CRA welcomes feedback whenever it consults, and it is known to integrate advice when developing positions on certain structures. Mr. Adams said that the CRA's position will evolve, and he acknowldeges that the CRA has more work to do in the GAAR area (updating the GAAR circular, for example).

Robert Couzin

Robert Couzin said that there are now two new abbreviations in the tax lexicon as a result of *Canada Trustco*: TCP (text, context, and purpose) and CPF (consistency, predictability, and fairness). Mr. Couzin noted that there is tension between these

56 *The Queen v. Singleton*, 2001 DTC 5545; [2002] 1 CTC 121 (SCC).

two concepts. For example, provisions that seem clear on the surface are not always clear upon further analysis; therefore, we are not likely to get much more consistency, predictability, and fairness than we did before.

From a practical perspective, we must determine which party has the burden of proving which assertions in the Tax Court; but most of what practitioners do will not end up in the Tax Court (or so one hopes). The onus, therefore, is not on one side or the other; the onus is really on practitioners to figure out what the TCP analysis is and how the process will work in order to give an opinion.

In the past, most commentators who analyzed the GAAR observed a difference between subsection 245(3) and subsection 245(4). As the courts developed their analysis of these provisions, a three-step approach evolved, rather than a unified application of the rule. The general view was that taxpayer motivation or intention was relevant to subsection 245(3) and had nothing to do with whether the taxpayer's intention was abusive. *Canada Trustco* makes it clear that this analysis is no longer correct. There are many references in the case to the relevance of taxpayer motivation in determining whether or not a transaction is an abuse; thus, the concept of taxpayer motivation is growing. Practitioners are not mind readers and cannot always know the taxpayer's motivation, which makes it difficult to advise clients in certain situations.

David Smith

David Smith commented first on the *Mathew* case. The court stated that income or losses flow through only to persons who are partners at the end of a taxation year; nothing in the language of section 96 states that. The court's interpretation appears to be incorrect because professional firms have long been allocating part of a fiscal period's income to departing or retiring partners, and that practice has never been an issue. In fact, the explanatory notes of proposed subsection 96(1.01)[57] reaffirm that one does not have to be a partner at the end of a taxation year to have income or losses allocated to him or her. Mr. Smith could not understand what the court was trying to articulate when it repeatedly made comments about partners pursuing the business activities of a partnership in a non-arm's-length relationship. The court did not have to venture into section 96 to analyze the underlying rationale of subsection 18(13).

In *Canada Trustco*, it appears that one will be able to use the explanatory notes as a permissible extrinsic aid, since the court itself frequently referred to the explanatory notes. This sometimes poses difficulties. For example, there are no explanatory notes for some provisions of the Act, especially older provisions. In *Hill v. The Queen*,[58] for example, no one could establish why compound interest was computed

57 Canada, Department of Finance, *Explanatory Notes to Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, July 2005), clause 90.

58 Supra note 53.

on a paid basis and simple interest was computed on a payable basis. Another problem with explanatory notes is that they simply repeat the wording of the legislation and do not offer any insight into the purpose of the provision.

Mr. Smith then raised a question about the relationship between specific anti-avoidance rules and the GAAR. For example, if the taxpayer survives a specific anti-avoidance provision, can the GAAR still apply? The court in *Canada Trustco* seemed to imply that a fresh examination can be embarked upon. In *Univar*,[59] however, Bell J compared subsection 95(6) to the GAAR provision, and he approached the two provisions in similar ways.

It has been reinforced that GAAR cases are highly fact-sensitive; therefore, we will see a great deal of effort on the part of the CRA to obtain every piece of information that might potentially be evidence. The CRA can see that GAAR cases will be won and lost on the facts; therefore, the more information that can be brought to bear, the better.

It appears that in *Canada Trustco* the court has attempted to reach a fair compromise. One can see that the court was wrestling with a section to which it had to give effect. The court was also wrestling with a rule that was "engrafted onto the statute," which created an even greater challenge for the court. The balance that the court tried to strike has left the Tax Court judges with quite a bit of leeway in deciding GAAR cases. The court made it clear that the CRA must anchor or ground its arguments in the sections of the Act that it thinks are being abused; it is not enough for the CRA to simply state that the transaction is circular or abusive.

A number of statements in *Canada Trustco* give Tax Court judges greater flexibility in deciding GAAR cases. The Supreme Court acknowledged that the "line between legitimate tax minimization and abusive tax avoidance . . . is far from bright,"[60] and referred to the GAAR as "a provision of last resort."[61] The court also made a comment on latent ambiguity, stating that "[e]ven where the meaning of particular provisions may not appear to be ambiguous at first glance, statutory context and purpose may reveal or resolve latent ambiguities."[62] According to Mr. Smith, it appears as if the court is stating that when one first examines the provision, it is not ambiguous; but when one looks at it more carefully, there is actually a great deal of ambiguity. This statement appears to give a Tax Court judge more latitude in finding ambiguity, and therefore more room to examine the context and purpose of the provision to resolve that ambiguity. If the Tax Court proceeds on a proper construction of the findings supported by the evidence, the appellate tribunal should not interfere.

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59 Supra note 54.

60 *Canada Trustco*, supra note 1, at paragraph 16.

61 Ibid., at paragraph 21.

62 Ibid., at paragraph 47.

Scott Wilkie

Following up on Mr. Smith's comments, Scott Wilkie noted that one needs well-prepared documentation that goes as far back as the initial transactions. The minister has a number of significant tools in sections 231.1 and 231.2, which historically have been used with caution and reluctance but may be used with more enthusiasm in the future to obtain all the facts in GAAR cases. While the Department of Finance may be satisfied to leave the GAAR as it is, one wonders whether there will be a temptation to enact more specific anti-avoidance rules.

Round Table Discussion: Tax-Avoidance Scenarios

Following these comments, the panel considered three tax-avoidance scenarios: the *Duke of Westminster* case, and two cases currently before the GAAR Committee (one involving the payment of a stock dividend in order to produce a capital loss to shelter a capital gain, the other involving an arrangement to avoid the non-resident trust rules in subsection 94(1)).

Duke of Westminster

The *Duke of Westminster* case stands for the well-known principle that a taxpayer has the right to take all legal steps to minimize his or her tax liability. This case has been cited with approval in numerous tax cases, including *Canada Trustco*. In the *Duke of Westminster* case, the taxpayer chose to pay his employees via a form of contract in which payments were tax-deductible, as opposed to non-deductible personal living expenses.

Wayne Adams said that today the *Duke of Westminster* case would probably go to the GAAR Committee, because the taxpayer changed the name of the payments to his employees to convert non-deductible amounts to deductible amounts for tax purposes. If the committee received a case like this, it would request a legal opinion on the true relationship between the taxpayer and his employees and discuss doctrines such as sham and legal substance before it considered arguing GAAR. If we assume that the legal substance test has been met in this case, one might ask whether the CRA is guilty of inferring sham rather than establishing sham. If the employees were being paid a so-called pension and were still expected to come to work, Mr. Adams concluded, the transaction should be regarded as an avoidance transaction.

Stock Dividend/Capital Loss Scenario

The CRA is applying the GAAR in a widespread arrangement involving the use of stock dividends to generate the creation of a capital loss. This type of transaction is normally undertaken by individuals or corporations that have realized a significant capital gain on an arm's-length sale. The series of transactions involving the stock dividend are undertaken to create a capital loss to counter the gain. The six specific steps in this scenario are as follows:

1. Mr. X sells his Opco shares and realizes a capital gain of $50 million, assuming a nominal adjusted cost base (ACB).
2. Mr. X receives full proceeds in cash.
3. Mr. X incorporates Newco, which issues him 1,000 class C shares for $1,000 with an ACB of $1 per share. These shares are voting but non-participating.
4. Mr. X subscribes for 100 common shares of Newco for $50 million cash (the cash received from the sale of his Opco shares). (See figure 1.)
5. Newco declares a high-low stock dividend on the common shares. The stock dividend consists of preferred shares having a paid-up capital (PUC) of $100, which are redeemable for $50 million. The fair market value (FMV) of the preferred shares is thus equal to the redemption amount. Therefore, the value of the common shares of $50 million is shifted to the preferred shares. (See figure 2.)
6. Mr. X establishes a family trust, of which his wife and children are the beneficiaries. The trustee is a trusted acquaintance of Mr. X. Mr. X sells the common shares of Newco to the family trust for $1 and realizes a capital loss of $50 million, which is applied to offset the capital gain realized on the sale of the Opco shares. (See figure 3.)

The tax consequences are as follows. Mr. X applies the capital loss to the gain previously realized. The stop-loss rules do not apply because the trust is not an affiliated person pursuant to section 251.1. The dividend income to Mr. X from the stock dividend is nominal because of the definition of "amount" in subsection 248(1) (that is, it is equal to the increase in PUC). Also, high-low shares are acceptable where corporate law permits.

The CRA is likely to refer to paragraph 60 of the *Canada Trustco* decision and to *Mathew*, in which the Supreme Court stated that "[t]he abusive nature of the transactions is confirmed by the vacuity and artificiality of the non-arm's length aspect of the initial relationship between Partnership A and STC."[63] With respect to artificiality, three pre-GAAR factors are adopted by the courts for subsections 245(1) and 55(1):

1. Would the deduction, if permitted, be contrary to the object and spirit of the Act?
2. Are the transactions giving rise to the deduction made in accordance with normal business practice?
3. Were the transactions entered into for bona fide purposes?

On examination, a comparison of the pre-GAAR cases with the *Canada Trustco* decision points to similar factors in the application of the GAAR—the object and spirit of the provisions, normal business practice, and bona fide purposes for a transaction.

63 *Mathew*, supra note 2, at paragraph 62.

FIGURE 1 Incorporation of Newco and Issue of Common Shares

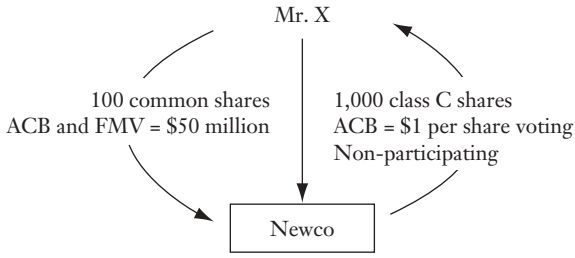


FIGURE 2 High-Low Stock Dividends

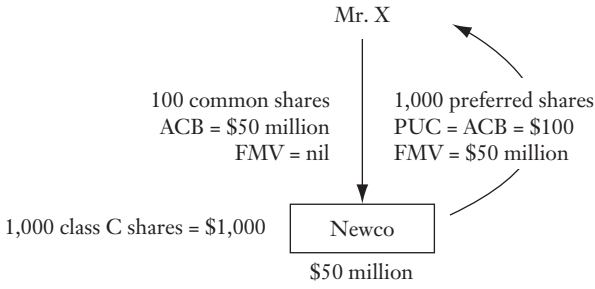
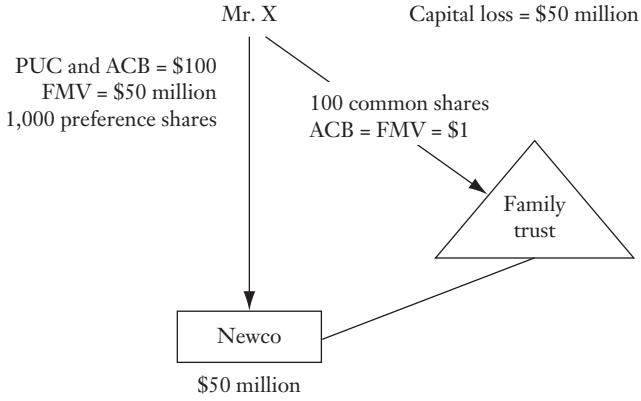


FIGURE 3 Sale of Common Shares



But for the introduction of the GAAR, the CRA would have used subsection 55(1) to challenge Mr. X's arrangement. However, the introduction of section 245 was accompanied by the repeal of subsection 55(1). The 1988 technical notes state that the GAAR is broad enough to cover the transactions to which subsection 55(1) was intended to apply.[64] Because the Supreme Court in *Canada Trustco* embraced the explanatory notes, the GAAR is the CRA's sole position in this case.

David Smith asked the two CRA panellists which specific provisions of the Act have been abused in the scenario. Sharon Gulliver indicated that the GAAR Committee will look at both the creation of the ACB and the stock dividend provisions and what they are meant to accomplish. She opined, from a contextual point of view, that this series of transactions is abusive within the scheme of the Act owing to the artificiality of the loss.

Other comments from the panel included the following:

- We will see quick and specific anti-avoidance rules going forward (Robert Couzin).
- The CRA could argue that the common and preferred shares were issued for the $50 million; that would answer the case without going to the GAAR (David Smith).
- In the United States, the Internal Revenue Service lists transactions that it does not like. One often wonders why the CRA does not issue press releases stating that it will attack certain transactions (David Smith). (In response, Sharon Gulliver indicated that the CRA is posting on its recently launched Taxpayer Alert Web site the arrangements it considers abusive.)

Non-Resident Trust Scenario

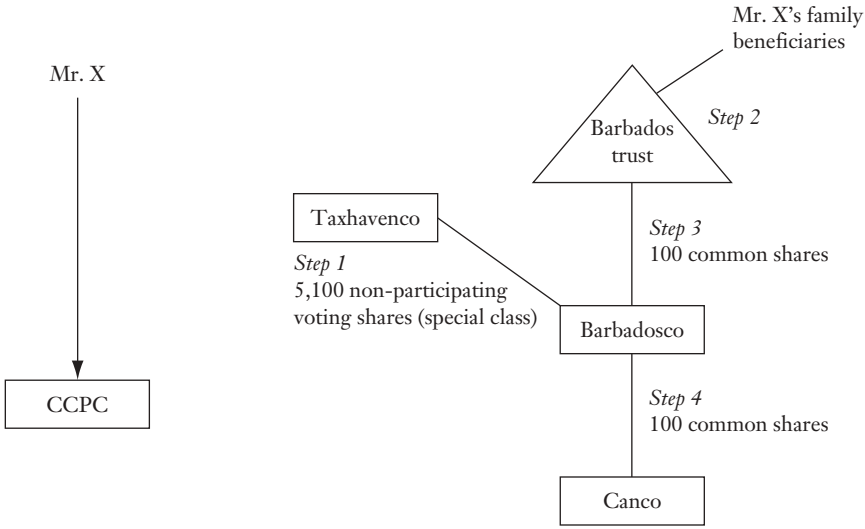
Another scenario involved the use of a non-resident trust to move offshore an anticipated future taxable capital gain. Generally, subsection 94(1) applies where a non-resident trust, or a corporation that would be its controlled foreign affiliate, acquired property, directly or indirectly in any manner whatever, from a Canadian beneficiary or a related person who was resident in Canada. Where the provision applies, a discretionary trust is deemed to be resident in Canada for the purposes of part I of the Act, and its income is deemed for tax purposes to be the total of its Canadian-source income and its foreign accrual property income (FAPI).

The steps in the transaction are as follows (see figure 4):

1. Mr. X is the sole shareholder of a Canadian-controlled private corporation (CCPC). He is planning to sell the CCPC.
2. A Barbados corporation, Barbadosco, in incorporated. Barbadosco is owned by Taxhavenco, a corporation in the Cayman Islands. Taxhavenco owns 5,100 non-participating voting shares of Barbadosco.

64 Supra note 6, at subclause 34(1).

FIGURE 4 Non-Resident Trust (Subsection 94(1))



3. A Barbados trust is created. The beneficiaries are Mr. X and his family, all of whom are resident in Canada. The settlor of the trust is never a Canadian and is not related to Mr. X or his family.
4. The Barbados trust acquires 100 common shares of Barbadosco. An important fact is that Barbadosco is a controlled foreign affiliate of Taxhavenco.
5. Barbadosco acquires 100 common shares of a newly created Canco.
6. Mr. X carries out an estate freeze. He transfers his shares of the CCPC to Canco on a rollover basis, taking back preferred shares of Canco with a redemption amount of $10 million. That amount is presumed to be equal to the FMV of the CCPC shares. Barbadosco now owns the future growth (now offshore) of the CCPC.
7. Within three years, the Canco shares are sold to an arm's-length party for $30 million. Mr. X receives $10 million for the preferred shares; Barbadosco receives $20 million for the growth shares. Pursuant to the Canada-Barbados tax treaty, Barbadosco claims a treaty exemption under subparagraph 110(1)(f)(i). The funds can then be distributed to the Barbados trust beneficiaries (Mr. X's family members) as a tax-free capital payment.
8. In summary, the structure allows the Canadian taxpayer to move offshore a capital gain and claim a treaty exemption, while the taxpayer's Canadian-resident family is entitled to receive the proceeds.

In *Canada Trustco*, the court stated that "[a]n abuse may also result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or

purpose of those provisions."[65] For subsection 94(1) to apply, there has to be a transfer of property to a trust, or a corporation owned by the trust, by the beneficiary or a person related to the beneficiary resident in Canada. Mr. X attempted to avoid that problem by arranging for a settlor of the trust to be an unrelated non-resident.

Sharon Gulliver pointed out an assessment problem due to the controlled foreign affiliate status of Barbadosco. If the CRA were to find that there was a transfer from Mr. X to the Barbados trust, Canco would not be a controlled foreign affiliate of Barbadosco because Taxhavenco holds the voting shares of Barbadosco. The CRA would therefore apply subsection 95(6) to deem those shares not to be issued.

Then, relying on *The Queen v. Kieboom*,[66] the CRA would argue that subsection 94(1) applies prima facie because there has been a transfer of property (the economic growth is property), directly or indirectly in any manner whatever, to the offshore corporation or a trust. There is also a possible argument to be made under subsection 69(11), depending on the interpretation of "substituted property," because Mr. X relies on a tax-free rollover to transfer property, the property is disposed of within three years, and the gain is protected by an exemption. Both of these provisions are anti-avoidance provisions. The GAAR would be an alternative position.

David Smith commented that he was glad that Sharon Gulliver had grounded her arguments on specific provisions of the Act. In both scenarios, the Supreme Court of Canada's recent decisions in *Canada Trustco* and *Mathew* are not considered to affect the CRA's continued prosecution of the matters.

FINAL COMMENTS BY CHIEF JUSTICE DONALD BOWMAN

Bowman CJ commenced by stating that Tax Court judges should be careful about their findings of fact. In writing judgments, they should be very specific about findings of fact, notwithstanding the problem that findings of fact are sometimes intertwined with and difficult to distinguish from questions of law or of mixed fact and law.

Counsel for the taxpayer and the Crown must think of the practical issues raised in a GAAR case. The first question is how one proves or disproves the existence of a tax benefit. The Supreme Court stated that this is a factual determination. In most cases, it will be obvious, because most taxpayers will admit that there is a tax benefit. But this will not always be the case. The Supreme Court stated that a tax benefit can be established only by a comparison of alternatives. Does this mean that a taxpayer must pick the most fiscally inefficient way of doing business? If that is the case, then there will always be a tax benefit. While paragraph 63 of *Canada Trustco* states that the burden is on the taxpayer to refute the allegation of a tax benefit, Bowman CJ thought it not unfair to expect the Crown to state, at a minimum, what

65 *Canada Trustco*, supra note 1, at paragraph 45.

66 92 DTC 6382; [1992] 2 CTC 59 (FCA).

the tax benefit is. This leads to the question whether the minister also has some obligation to show the route that the taxpayer should have chosen.

Assuming that the basis of the minister's assessment is clearly articulated, the taxpayer can deal with this assessment in three different ways. The taxpayer can admit that there is a tax benefit (and in most cases the taxpayer will do this), or the taxpayer can say that the alternatives were unfeasible or impractical. Assuming that there is a tax benefit, the second branch of inquiry is whether the transaction was undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. Again, the Supreme Court stated that this is a factual determination and that the onus resides with the taxpayer. But how does the taxpayer meet this onus? Arguments of subjective intent are not very convincing, and the taxpayer would probably have to show an objective result.

The Supreme Court has said that economic substance is important. But how does one prove economic substance? Is it a question of fact, law, or mixed fact and law, or is it a question of opinion? Bowman CJ would like to hear argument on this in the future.

Bowman CJ said that the next branch of inquiry—whether the onus of proof has been met—is the most difficult. This is a factual issue, not a legal issue. As a result, the onus that the Supreme Court of Canada places on the minister to establish the abusive nature of the transaction at issue must refer not to a burden of proof, but rather to a burden of persuasion.

It is not clear what constitutes a question of fact in discovering abusive tax avoidance. What sort of facts should one put in to show that a transaction is abusive? If the minister does not call evidence to show abusive tax avoidance, has the minister not met the onus and, therefore, should the appeal be dismissed?

The types of evidence or permissible extrinsic aids that could be entered in a GAAR case include the explanatory notes, which the Supreme Court itself used. Bowman CJ said that he was very reluctant to look to the government to determine what the rules mean; therefore, interpretation bulletins are not very helpful. However, if the interpretation bulletin assists the taxpayer, Bowman CJ will refer to it. If the interpretation bulletin upholds the government's position, he will not use it, because that is "dirty pool." He observed that more and more items are being produced as evidence which perhaps should not be produced.

Another question is how to enter extrinsic aids. For example, should the person who drafted the rules from the Department of Finance be subject to cross-examination? Should the parties be producing expert witnesses to prove the object, spirit, and intent of the provision? The Tax Court will need to develop rules governing how extrinsic evidence can be entered. These are some of the evidentiary problems that we will face time and time again.

Once the Crown decides that there is an abuse, it has to act reasonably. If the court decides that the GAAR applies, has the minister applied the right remedy? In the view of Bowman CJ, if the taxpayer does not like the remedy or the recharacterization of the result by the minister, then the taxpayer should be able to contest the proposed remedy before the court.

CONCLUSION

The symposium provided an opportunity for a useful exchange among academics, practitioners, and representatives of the CRA on the Supreme Court of Canada's decisions in *Canada Trustco* and *Mathew* and on the GAAR more generally. Difficult questions were raised concerning the economic substance doctrine, retroactivity, the balance between the TCP and CPF concepts raised in *Canada Trustco*, the onus of proof, and the permissible evidence to be entered in court in proving or disproving a GAAR transaction. One must be be mindful of the fact that the CRA's views of the Supreme Court of Canada's decisions and the GAAR will continue to evolve as the Tax Court applies these decisions in future cases. Tax practitioners will need to be aware of these developments and how they will affect tax planning.