A Reasoned Response to the CRA's Views on the Scope and Interpretation of Paragraph 95(6)(b)*

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PRÉCIS

Le paragraphe 95(6) est une règle anti-évitement précise qui fait partie des dispositions de la *Loi de l'impôt sur le revenu* sur les sociétés étrangères affiliées. En vertu de ce paragraphe, une acquisition d'actions d'une société étrangère qui, autrement, serait une société étrangère affiliée d'un contribuable canadien peut être ignorée dans certaines circonstances. Au cours des dernières années, l'Agence du revenu du Canada (ARC) a dévolu au paragraphe 95(6), en particulier à l'alinéa 95(6)b), un rôle qui en ferait une règle anti-évitement d'application générale, sensiblement identique à la règle générale anti-évitement (RGAÉ) du paragraphe 245(2). L'ARC pourrait alors appliquer la règle à sa discrétion lorsque l'acquisition d'actions, ou la série d'opérations dont fait partie l'acquisition d'actions, entraîne ce que l'ARC considère comme un évitement abusif de l'impôt.

Dans cet article, les auteurs examinent l'historique du paragraphe 95(6) et l'évolution des positions de l'ARC. Ils appliquent une analyse textuelle, contextuelle et téléologique à cette disposition dans le but de démontrer que l'interprétation qu'en fait l'ARC n'est justifiable selon aucune de ces analyses.

ABSTRACT

Subsection 95(6) is a specific anti-avoidance rule found in the foreign affiliate provisions of the Income Tax Act. Under the subsection, a share acquisition in a foreign corporation that would otherwise qualify as a foreign affiliate of a Canadian taxpayer may be ignored in certain circumstances. In recent years, the Canada Revenue Agency (CRA) has asserted a role for subsection 95(6), and in particular for paragraph 95(6)(b), that would elevate it to the status of an avoidance rule of general application, much like the general anti-avoidance rule (GAAR) in subsection 245(2); the CRA could then apply the rule on a discretionary basis where the share acquisition, or the series of transactions of which the share acquisition is a part, results in what the CRA considers to be abusive tax avoidance.

In this article, the authors examine the history of subsection 95(6) and the evolution of the CRA's positions. They apply a textual, contextual, and purposive analysis to the

* Authors' note: This article was written before the November 9, 2006 Notice of Ways and Means Motion (which includes certain changes to the proposed foreign investment entity and non-resident trust rules) was tabled and does not take into account any changes proposed therein.

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provision with the objective of demonstrating that the CRA's interpretation is not supportable on any such reading.

KEYWORDS: ANTI-AVOIDANCE ■ FOREIGN AFFILIATES ■ STATUTORY INTERPRETATION ■ INTERNATIONAL TAXATION

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INTRODUCTION

The scope of subsection 95(6) has been hotly debated in recent years. Subsection 95(6) is a specific anti-avoidance provision applicable only for the purposes of subdivision i of part I, division B of the Income Tax Act (Canada)[1] (in which the "foreign affiliate" provisions of the Act are principally found). A foreign corporation's status as a foreign affiliate in relation to a Canadian taxpayer is important for a variety of reasons.

The purpose of this article is to consider the proper interpretation of subsection 95(6) and, in particular, paragraph 95(6)(b): on a textual, contextual, and purposive analysis, is the provision an avoidance rule of general application, as the Canada Revenue Agency (CRA) has asserted in recent years, or is it a specific anti-avoidance rule with a more modest scope? We make the case that subsection 95(6) is not a wolf in sheep's clothing: instead, it is a fairly limited specific anti-avoidance rule that does not fit the role ascribed to it by the CRA. In short, it is being used by the CRA in an ill-founded and inappropriate manner that is out of step with its ordinary meaning, context, and purpose, that is inconsistent with the relevant explanatory notes issued by the Department of Finance as an aid to its proper interpretation, and that results

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

in an unnecessary and unintended overlap of the provision and the general anti-avoidance rule (GAAR) in section 245.

Nothing in the legislative history of subsection 95(6) hints that it was intended to be an avoidance rule of general application in relation to the foreign affiliate rules. Yet that is the role that has been ascribed to it by the CRA, both as the basis for reassessments that have actually been issued and as the basis for current and future assessing practice.

GENERAL SUMMARY OF THE FOREIGN AFFILIATE RULES

A detailed discussion of the foreign affiliate regime is beyond the scope of this article. However, two fundamental tenets of the regime are central to an understanding of the context of subsection 95(6). The first principle is that a taxpayer should not be able to avoid Canadian tax on investment income by earning it through a foreign corporation that is controlled by the taxpayer or by the taxpayer and a limited number of other parties. This principle is embodied in rules under which a Canadian taxpayer's share of the passive income earned by a controlled foreign affiliate of the taxpayer is taxed on a current basis in Canada; the rules achieve this objective by providing for an imputation system under which an appropriate percentage of the foreign accrual property income (FAPI) of a controlled foreign affiliate of a Canadian resident is treated as currently taxable income of that Canadian resident. FAPI generally includes most forms of investment income of the controlled foreign affiliate, such as interest, dividends, royalties, and non-active-business income.

The second principle that underlies the regime is that active business income of a foreign affiliate of a Canadian taxpayer should be taxed only when it is repatriated to Canada in the form of dividends. Further, dividends received by Canadian corporations out of the active business income of their foreign affiliates should be taxed with appropriate recognition for the place where that income is earned (that is, in a designated treaty country or not) and for the foreign tax burden to which the income has already been subjected. The regime assumes that if income has its source in a jurisdiction with which Canada has a tax treaty, that jurisdiction imposes a level of tax on the relevant income that is appropriate and accepted by Canada as such.[2]

2 Regulation 5907(11) now generally provides (supplemented by certain rules in regulations 5907(11.1) and (11.2)) that a country is a "designated treaty country" if Canada and that country have entered into a comprehensive agreement or convention for the elimination of double taxation on income that has entered into force and has effect. The current rules came into effect with respect to taxation years of foreign affiliates that began after 1995. The repealed version of regulation 5907(11) contained a list of countries; if the affiliate was resident in one of those countries, earnings from active businesses carried on there or in any other listed country qualified as exempt earnings. The "listed country" approach was (according to the Department of Finance's explanatory notes) intended to produce a list of countries with which Canada had a treaty; however, some countries with which negotiations were undertaken were listed in anticipation of a treaty being ratified, but the relevant treaty was never ratified or, in some cases, concluded. (See Canada, Department of Finance, *Explanatory Notes to Revised Draft Amendments—*

It is this aspect of the foreign affiliate regime that is most germane to the proper interpretation of paragraph 95(6)(b). Generally, dividends received by a Canadian resident from a foreign affiliate must be included in income under section 90. A Canadian-resident corporation is entitled to claim certain deductions in computing its taxable income in respect of such dividends under section 113. The amount of those deductions depends on the nature of the affiliate's earnings from which the dividend is sourced—that is, whether such earnings are active or non-active, the country in which the affiliate is resident, and the source country of the earnings.

If a foreign affiliate of a Canadian corporation is resident in a designated treaty country, dividends derived from earnings in that or another designated treaty country from an active business are considered to be paid out of the affiliate's exempt surplus, and they are fully deductible in computing the Canadian taxable income of the Canadian corporation as a result of the rules in section 113. Dividends that are received from a foreign affiliate that is not resident in a designated treaty country, or that are derived from income that is not active business income earned in such a country, are considered to be paid out of the foreign affiliate's taxable surplus; they are subject to tax in Canada when they are repatriated in the form of a dividend, after certain deductions are allowed in respect of foreign income tax (including withholding tax) that applies to such dividends.

An important deeming rule in this connection is subparagraph 95(2)(a)(ii), under which income that would otherwise be FAPI is recharacterized as active business income if specified conditions are met. Specifically, subparagraph 95(2)(a)(ii) deems income received by a foreign affiliate of a Canadian corporation from a non-resident corporation to which the affiliate and the Canadian corporation are related to be active business income of the affiliate, to the extent that the amount received is deductible in computing the active business earnings of the paying non-resident corporation.

Income Tax Regulations (Ottawa: Department of Finance, January 1995).) The list also did not include some countries that had entered into a ratified treaty. The approach in the revised regulations was intended to achieve the objective of ensuring that a country is automatically included as a designated treaty country when a treaty takes effect. It is reasonable, in our view, to speculate that the CRA's current approach to paragraph 95(6)(b) reflects the fact that it does not believe that certain countries with which Canada has a ratified, in-force tax treaty should be considered to be designated treaty countries to the extent that they continue to function in certain respects as tax havens. However, where this occurs (as in the case of Barbados), it seems to be a deliberate policy choice on the part of the Department of Finance. The regulations themselves contain a general rule under which a foreign affiliate is considered to be resident in the designated treaty country only if it is resident in that country under Canadian common-law tests of residence and under the provisions of Canada's ratified treaty with that country. In the case of a treaty that entered into force before 1995 (the relevant provisions of which have not been amended since), a foreign affiliate is deemed by regulation 5907(11.2)(c) to be resident in the treaty-partner country if it would be resident if the treaty applied to the affiliate. This provision was specifically intended to permit Barbados international business corporations (which are carved out of the Canada-Barbados treaty: Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Bridgetown on January 22, 1980) to qualify as residents of a designated treaty country for the purposes of regulation 5907(11).

The result is that the active business income status of the particular amount is effectively preserved by virtue of its being an expense incurred by the related foreign payer in computing its active business income, and the income does not become FAPI of the recipient affiliate.

Subparagraph 95(2)(a)(ii) is an integral component of the foreign affiliate rules and, in one form or another, has been part of the rules since their introduction in 1974. This provision reflects Parliament's intention to ensure that Canadian corporations may finance foreign affiliates that in turn earn interest income from making loans to related non-resident corporations, and that such interest income may, where subparagraph 95(2)(a)(ii) applies, be repatriated to Canada as tax-deductible exempt surplus dividends. In fact, the provisions of subparagraph 95(2)(a)(ii) were recently amended by Parliament and continue to ensure this result, as noted below; in practical terms, however, their scope has been narrowed by the specific anti-avoidance rules in subsections 17(2) and (3), which we discuss later in this article.

The definitions of the terms "foreign affiliate" and "controlled foreign affiliate" are found in subsection 95(1). Both definitions prescribe bright-line formulaic tests for determining the status of a non-resident corporation in relation to a Canadian-resident taxpayer. We will not review the definitions in detail; however, to understand the context of the rules in subsection 95(6), it is necessary to have a basic understanding of the rules for determining the status of a corporation as a foreign affiliate or a controlled foreign affiliate of a Canadian taxpayer.

Generally, ownership (direct or indirect) of 1 percent of any class (or series) of shares of a foreign corporation by a Canadian-resident taxpayer results in the foreign corporation being a foreign affiliate of the resident taxpayer if the resident's holdings, when combined with the holdings of any related person, amount to 10 percent or more of the class or series. Thus, the threshold of ownership necessary for a foreign corporation to be a foreign affiliate of a Canadian-resident taxpayer is (deliberately, it seems) low. In contrast to other provisions of the Act,[3] there is no requirement that the shares of the foreign corporation represent a specified percentage of the value of all issued and outstanding shares of the corporation, nor is there any requirement that the holder have any prescribed percentage of the voting power attached to the issued share capital. For example, merely by holding 10 percent of a class of fixed-value, non-voting, preferred shares issued by a foreign corporation, a Canadian holder can satisfy the requirements in the definition that cause the foreign issuer to be a foreign affiliate of the Canadian holder.

The definition of "controlled foreign affiliate" is, arguably, somewhat more subjective. However, determination of controlled foreign affiliate status is still largely a matter of applying a formulaic test. A corporation must first be a foreign affiliate of a Canadian-resident taxpayer; then, if it is controlled by the taxpayer or would be

3 For example, compare the definition of a connected corporation in subsection 186(4), under which (unless a control test is met) the relevant test requires that the shareholder have more than 10 percent of the shares of the investee corporation, on a votes-and-value basis, for the investee corporation to be connected with the investor corporation.

considered to be controlled by the taxpayer if certain assumptions are made, it will be a controlled foreign affiliate of the taxpayer.

Reduced to their essence, the assumptions that are required to be made are (1) that the taxpayer owns any shares of the foreign affiliate that are owned by any person that does not deal at arm's length with the taxpayer, and (2) that the taxpayer owns any shares that are actually owned by not more than four other persons resident in Canada. For the purpose of the second assumption, ownership of any shares owned by any person not at arm's length with any Canadian resident is attributed to the Canadian resident.

In the definition, "control" means de jure control; that is, the words "controlled, directly or indirectly in any manner whatever," which signal that the de facto control test in subsection 256(5.1) is engaged, are not used. Therefore, the meaning of "control" should be based on the common-law test, which looks primarily to ownership of that number of shares which entitles the holder or holders to elect a majority of the board of directors (in the absence of a unanimous shareholder agreement that may remove the power to manage the corporation from the directors).

In the simple case where there is one class of voting common shares and there is no unanimous shareholder agreement, a foreign affiliate can become a controlled foreign affiliate of a Canadian-resident taxpayer because more than 50 percent of the shares are held by a combination of the Canadian resident and non-arm's-length parties, or because more than 50 percent of the shares are held (or are considered to be held) by a combination of the Canadian-resident taxpayer and up to four other arm's-length Canadian residents.

Foreign affiliate status can be beneficial or detrimental, depending on the circumstances. Owing to the deductions in computing taxable income that are permitted by section 113, a Canadian corporation can derive substantial benefits from receiving dividends on shares of a foreign affiliate. On the other hand, controlled foreign affiliate status is generally to be avoided, at least if the foreign affiliate earns passive income that constitutes FAPI; such status may result in the imputation of all or a portion of the FAPI of the controlled foreign affiliate to Canadian residents on the basis of the participating percentage of the Canadian residents in the controlled foreign affiliate.

Because the bright-line nature of the tests set out in the definitions makes it relatively easy to manipulate share ownership (through options and other arrangements) either to achieve foreign affiliate status or to escape controlled foreign affiliate status, depending on the taxpayer's objectives, it is not surprising to find that a constructive ownership rule such as that in subsection 95(6) was considered necessary.

SUBSECTION 95(6): WHY IT EXISTS AND WHAT IT SAYS

The rules in subsection 95(6) are, in their most basic terms, constructive ownership rules that are aimed at preventing the artificial manipulation of share ownership in order to reap the benefits that flow from a foreign corporation having foreign affiliate

status or "related" status, or to avoid the negative consequences of a foreign corporation being a controlled foreign affiliate of a taxpayer. They are not unlike the rules in paragraph 251(5)(b) (and other similar rules), which provide that where a taxpayer manipulates share ownership (through the use of options, voting trust agreements, share purchase agreements, or otherwise) in order to avoid the consequences of control, affiliation, or relatedness, share ownership may be attributed to a taxpayer who does not legally or beneficially own the shares, on the basis of rights to acquire, or to vote, the shares or on other indicia of control or future rights to acquire ownership.

Subsection 95(6) contains two rules, in paragraphs (a) and (b). Both rules apply only for the purposes of subdivision i of part I, division B, and neither rule has any application for the purpose of section 90 (which requires a Canadian resident to include in income any dividend received on a share of a corporation not resident in Canada).[4]

Paragraph 95(6)(a) is a rule that is similar to the deemed ownership rule in paragraph 251(5)(b). It is primarily concerned with the avoidance or manipulation of the foreign affiliate and controlled foreign affiliate definitions, and certain other key rules, through the use of options. Because paragraph 95(6)(a) is not the focus of recent interest, we will not discuss it in detail. In general terms, it applies where any person or partnership has a right to, or to acquire, shares of a corporation (or interests in a partnership). If it can reasonably be considered that the principal purpose for the existence of any such right is to permit any person to avoid, reduce, or defer tax payable, or some other amount, under the Act, subparagraph 95(6)(a)(ii) deems the relevant shares (or partnership interest) to be owned by the person or partnership that enjoys the benefit of the right. This rule might be expected to operate, for example, where a particular person holds only an option on shares, and not the shares themselves, in order to avoid a FAPI inclusion that would result from controlled foreign affiliate status.

Under subparagraph 95(6)(a)(i), where it can reasonably be considered that the principal purpose for the existence of the right is to cause two or more corporations to be related for the purpose of paragraph 95(2)(a), the particular corporations are deemed not to be related. As noted earlier, paragraph 95(2)(a) contains a number of

4 A proposed amendment (Canada, Minister of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, July 2005), subclause 19(9)) would also make subsection 95(6) inapplicable for the purposes of sections 94 through 94.4. These proposed rules deal with non-resident trusts and foreign investment entities. The reason for extending the non-application of subsection 95(6) to these rules is not entirely clear. A similar amendment is proposed to be made to the opening words of subsections 95(1) and (2). Subsection 95(1) contains many of the definitions relevant to the foreign affiliate provisions, and subsection 95(2) contains certain key application rules. From discussions with the Department of Finance, we understand that the drafting assumption was that since the terms "foreign affiliate" and "controlled foreign affiliate" are defined for the purposes of the Act in subsection 248(1) by reference to the meanings of these terms assigned by subsection 95(1), any rule (such as the rules in subsection 95(6)) that applies for the purposes of such definitions should be taken into account when one is interpreting these terms in the context of sections 94 through 94.4, unless the definition is expressly modified when it is used in those sections. It appears that the Department of Finance may be reconsidering whether this drafting approach (which seems confusing to us) accomplishes the desired result.

rules under which income that would otherwise be considered passive (that is, FAPI) is recharacterized as active; but for many of the rules, it is key to determine whether or not the payer, the payee, and the Canadian corporation are related. This provision seems primarily concerned with the use of options to manipulate related-corporation status in order to benefit from the recharacterization rules.

Paragraph 95(6)(b), which has been the subject of most of the recent debate and is the key focus of this article, provides as follows:

> [For the purposes of this subdivision (other than section 90)] . . .
>
> (b) where a person or partnership acquires or disposes of shares of the capital stock of a corporation or interests in a partnership, either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, that acquisition or disposition is deemed not to have taken place, and where the shares or partnership interests were unissued by the corporation or partnership immediately before the acquisition, those shares or partnership interests, as the case may be, are deemed not to have been issued.

One of the effects of the application of paragraph 95(6)(b) (and its non-application for the purpose of section 90) is that where shares (or partnership interests) have been acquired, they are deemed not to have been acquired for the purposes of the foreign affiliate rules in subdivision i, except that dividends received on the shares must still be included in computing income. The most significant (and obvious) consequence of ignoring a share acquisition for the purposes of subdivision i is that if the particular share acquisition resulted in the issuing corporation having foreign affiliate status in relation to a Canadian-resident corporation, that status would not in fact have been achieved.

It is noteworthy that subsection 95(6) has no self-contained rule (such as that in subsection 245(4)) that negates its application when the transactions may be tax-motivated but the results are not abusive when measured against any objectively demonstrable policy in the Act. As we argue later, we believe that the absence of such an internal limit is key to an understanding of the intended purpose and scope of the rule and is one of the main flaws in the CRA's argument that paragraph 95(6)(b) is a general anti-avoidance rule that can, in essence, be applied at the discretion of the CRA.

In this article, we focus on what we believe to be the key words in paragraph 95(6)(b) in regard to the CRA's recent interpretive positions:

> where a person . . . acquires shares of . . . a corporation . . . and it can reasonably be considered that the principal purpose for the acquisition . . . is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act.

As we explain in more detail below, the conceptual underpinning of the current CRA initiatives is the CRA's belief that, despite what the words seem to us to clearly

state, the "principal purpose" test in paragraph 95(6)(b) may be satisfied on the basis of an overall purpose for a series of transactions of which a particular share acquisition may be a part. This belief underlies the CRA's view that, for example, if the tax benefit is primarily derived from the way in which the share acquisition was financed (say, interest-bearing debt) and not from the share acquisition itself, that fact alone may permit paragraph 95(6)(b) to be applied.

Further, the CRA seems to believe that the provision is a discretionary one. Even if, in the CRA's view, the share acquisition itself gave rise to the tax benefit, subsection 95(6) will not be applied unless the planning results in an abuse of some tax policy. For example, a Canadian corporation that was previously carrying on business in a foreign jurisdiction through a branch operation—typically, to allow startup losses to be deducted against income from the domestic operations—might decide to incorporate that branch when it becomes profitable so that the business income earned in the branch is not taxed in Canada on a current basis. In general, the CRA does not believe that paragraph 95(6)(b) should apply to such a share acquisition (or, at any rate, it has signalled that it will not apply paragraph 95(6)(b) to such a share acquisition).[5]

We do not argue with the CRA's restraint in applying a provision that is badly worded to fact patterns to which it clearly was not intended to apply. However, we have considerable difficulty with its treatment of paragraph 95(6)(b) as an anti-avoidance provision that applies at the CRA's discretion. Moreover, for the reasons set out below, such an approach should not be necessary if paragraph 95(6)(b) is given the textual, contextual, and purposive reading that we advocate.

Legislative History of Subsection 95(6)

A new system of taxation for international income was proposed as part of the 1971 tax reform. Certain aspects of the proposals as initially tabled were controversial, and as a consequence the introduction of the system was postponed. Two 1974 budgets, the first tabled on May 6 and the second on November 18, entirely redesigned the Canadian foreign affiliate taxation regime.[6] The spring budget, which introduced the foreign affiliate amendments (including new subsection 95(6)) as part of the government's revisions to the 1971 tax reform bill, was defeated in the House of Commons. The fall budget reintroduced the proposals of the spring budget with a

5 This example was identified as example 1 in "Canada Revenue Agency Panel," paper presented at the International Fiscal Association (Canadian branch) International Tax Seminar, May 9, 2005 ("the 2005 IFA presentation").

6 For a comprehensive summary of the history of the Canadian foreign affiliate system, see J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72.

number of refinements.[7] In general terms, the system that was implemented as a result of these changes is essentially the current foreign affiliate system, under which only FAPI of a controlled foreign affiliate is taxed on an imputation basis—that is, whether or not it is repatriated—and dividends received by a Canadian corporation from a foreign affiliate out of the active business income of the foreign affiliate are received without further Canadian tax if they are sourced in exempt earnings and with credit for foreign taxes if they are sourced in taxable earnings. The basic distinction between the two types of earnings was, as it is under present rules, based on the source of the earnings—that is, whether or not earned by a foreign affiliate resident in a treaty country from an active business carried on in such a country.

At the time of its introduction, subsection 95(6) read as follows:

> (6) For the purposes of this subdivision,
>
> (a) where any person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, to, or to acquire, shares of the capital stock of a corporation, those shares shall, if one of the main reasons for the existence of the right may reasonably be considered to be the reduction or postponement of the amount of taxes that would otherwise be payable under this Act, be deemed to be owned by that person; and
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> (b) where any foreign affiliate of a taxpayer or any non-resident corporation controlled, directly or indirectly in any manner whatever, by the taxpayer or by a related group of which the taxpayer was a member has issued shares of a class of its capital stock and one of the main reasons for the existence or issuance of one or more of the shares of that class may reasonably be considered to be the reduction or postponement of the amount of taxes that would otherwise be payable under this Act, those shares shall be deemed not to have been issued.[8]

In the February 1994 budget, the minister of finance tabled draft amendments to the foreign affiliate regime.[9] The amendments were revised in June 1994 and February 1995; they were enacted in June 1995 as part of Bill C-70.[10] The amendments made important changes to the foreign affiliate regime, including changes to paragraph 95(2)(a). In addition, several changes were made to subsection 95(6): they generally applied with respect to rights acquired and shares acquired or disposed of in taxation years of foreign affiliates of taxpayers that began after 1994.

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7 The 1974 budget proposals were ultimately enacted by SC 1974-75-76, c. 26. For a discussion of the 1974 foreign affiliate proposals, see J.M. Bradley, "Shareholders of Foreign Affiliates and Beneficiaries of Non-Resident Inter Vivos Trusts," in *Report of Proceedings of the Twenty-Sixth Tax Conference*, 1974 Conference Report (Toronto: Canadian Tax Foundation, 1975), 225-40; and A.P.F. Cumyn, "Foreign Accrual Property Income Under the 1974 Spring Budget," ibid., at 241-53.

8 SC 1974-75-76, c. 26, section 59.

9 Canada, Department of Finance, 1994 Budget, Tax Measures: Supplementary Information, annex 1.

10 Bill C-70, An Act To Amend the Income Tax Act, the Income Tax Application Rules and Related Acts, tabled February 16, 1995; given royal assent June 22, 1995.

After the 1995 amendments, subsection 95(6) read as follows:

> (6) For the purposes of this subdivision (other than section 90),
>
> (a) where any person or partnership has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, to, or to acquire, shares of the capital stock of a corporation and
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> (i) it can reasonably be considered that the principal purpose for the existence of the right is to cause 2 or more corporations to be related for the purpose of paragraph (2)(a), those corporations shall be deemed not to be related for that purpose, or
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> (ii) it can reasonably be considered that the principal purpose for the existence of the right is to permit any person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, those shares shall be deemed to be owned by that person or partnership; and
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> (b) where a person or partnership acquires or disposes of shares of the capital stock of a corporation, either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition or disposition of the shares is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, those shares shall be deemed not to have been acquired or disposed of, as the case may be, and where the shares were unissued by the corporation immediately prior to the acquisition, those shares shall be deemed not to have been issued.[11]

The February 1995 technical notes relating to amended subsection 95(6) explained the changes as follows:

> The amendment to the preamble of subsection 95(6) provides that the rule does not apply for the purposes of section 90 of the Act. Section 90 simply includes in the income of a taxpayer resident in Canada a dividend received by the taxpayer on a share of a non-resident corporation owned by the taxpayer.
>
> Paragraph 95(6)(a) has been amended in a number of ways. First, the "one of the main reasons test" is replaced by a "principal purpose" test consistent with the test in new paragraph (b). Second, it has been made to apply to persons and partnerships. Finally, it has been made to apply where the principal purpose for the existence of any right is to make two or more corporations related for the purposes of paragraph 95(2)(a) or to avoid, defer or reduce any amounts payable under the Act. In the first case, the corporations are deemed not to be related for the purposes of paragraph 95(2)(a) and, in any other case, the shares that could be acquired under the right are deemed to be owned.
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> Paragraph 95(6)(b) has been rewritten and applies to an acquisition or disposition of shares where the principal purpose for such acquisition or disposition was the avoidance, reduction or deferral of amounts payable under the Act. If the principal purpose

11 Further amendments were made in 1997 to the coming-into-force provisions in section 46 of An Act To Amend the Income Tax Act, the Income Tax Application Rules and related Acts, SC 1995, c. 21, in relation to subsection 95(6). The amendments did not affect the wording of subsection 95(6).

exists, the shares are deemed not to have been acquired or disposed of and previously unissued shares are deemed not to have been issued.[12]

Although the technical notes do not make the point expressly, the change to paragraph 95(6)(b)—so that it referred to the acquisition or disposition of shares of a "corporation" rather than to the issuance of shares by a "foreign affiliate" of the taxpayer (or by a corporation controlled by the taxpayer or by a related group of which the taxpayer was a member)—ensured its application to an acquisition of shares of a non-resident corporation that was not already a foreign affiliate of the taxpayer or a controlled corporation. Before the amendment, it might have been argued that paragraph 95(6)(b) was restricted in its application to shares issued by an existing foreign affiliate (or a controlled corporation).

On March 16, 2001, the Department of Finance released a notice of ways and means motion and accompanying explanatory notes[13] that included numerous amendments to the Act arising from the tax measures announced in the February 28, 2000 budget and the October 18, 2000 economic statement and budget update. The March 2001 notice of ways and means[14] contained certain technical amendments to subsection 95(6). The obvious import of these amendments was to expand both paragraphs (a) and (b) to include the acquisition (or disposition) of interests in partnerships.

Further minor amendments to subsection 95(6) have been proposed as part of the July 18, 2005 draft legislation regarding non-resident trusts (NRTs) and foreign investment entities (FIEs). These proposed changes, if enacted, will be applicable to taxation years beginning after July 18, 2005 and will amend the opening words of subsection 95(6) to provide that in addition to not applying for the purposes of section 90, the rules in subsection 95(6) do not apply for the purposes of sections 94 to 94.4.[15]

Parliamentary Debate on the Overall Foreign Affiliate Regime

Practical limitations make it impossible to review all of the parliamentary debate that has taken place over the years on the question of what constitutes an appropriate foreign affiliate regime.[16] We think that it is sufficient to observe that whatever the shortcomings of the existing regime may be, its key features are the result of deliberate tax policy choices. It may be difficult to understand why, in general tax policy

12 Canada, Department of Finance, *Amendments to the Income Tax Act, Explanatory Notes* (Ottawa: Department of Finance, February 1995), subclause 46(7).

13 Canada, Department of Finance, Notice of Ways and Means Motion and Explanatory Notes Income Tax Measures, March 16, 2001.

14 Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, the Income Tax Application Rules, Certain Acts Related to the Income Tax Act, the Canada Pension Plan, the Customs Act, the Excise Tax Act, the Modernization of Benefits and Obligations Act and Another Act related to the Excise Tax Act, March 16, 2001.

15 See the comments in note 4, supra.

16 For a detailed discussion of the relevant issues, see Wilkie et al., supra note 6, and Allan R. Lanthier, "Policy or Abuse? The Auditor General's Report" (1993) vol. 41, no. 4 *Canadian Tax Journal* 613-38.

terms, Canada continues to provide such a generous a system for taxing the income of foreign affiliates of Canadian corporations, but it must be concluded that either for pragmatic reasons (such as a lack of resources within the Department of Finance) or for policy reasons (a desire to ensure that Canadian tax rules are favourable in order to attract capital to Canada) the Canadian government has made a deliberate decision not to adopt a different approach.[17]

The existing foreign affiliate regime has received criticism from many quarters, most notably from Canada's auditor general, who has expressed concern on a number of occasions that the existing system of taxation of dividends from foreign affiliates has eroded Canadian tax revenues, particularly in combination with Canada's generous interest deductibility rules. In particular, the auditor general's report for the government's 1992 fiscal year, released on November 24, 1992,[18] was highly critical of the combined effect of the rules on interest deductibility, foreign-source income, and foreign affiliates, which the auditor general asserted had led to the loss of hundreds of millions of dollars in tax revenues. The Department of Finance replied that the tax rules were adequate and reflected its tax policy objectives and the legislative intent of Parliament. In its response (contained in the auditor general's report), that department stated that

> the existing foreign affiliate regime accurately reflects the policy intention of Parliament and provides for the taxation of all income that is intended to be subject to Canadian income tax.[19]

Although the Department of Finance did not go so far as to state that the system was completely without problems, it stated that

> [i]n formulating our policy with respect to the taxation of foreign source income, it was necessary to recognize that there are substantial costs inherent in implementing a system that deviates substantially from international norms . . . . Ultimately, Canada finds itself in the position of having to balance tax theory with the economic realities of the international marketplace.[20]

The consequence of this divergence of opinion between the auditor general and the Department of Finance was that on April 23, 1993, the Standing Committee on Public Accounts tabled a report in the House of Commons.[21] In testimony before

17 See the discussion of the 1992 auditor general's report that follows.

18 Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992), paragraphs 2.28-2.61.

19 Ibid., at 51.

20 Ibid., at 52.

21 Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, Twelfth Report to the House, 34th Parliament, 3d sess., 1991-92-93, issue no. 37, December 8, 1992; issue no. 38, December 10, 1992; issue no. 40, February 10, 1993; issue no. 43, March 9, 1993; and issue no. 48, April 23, 1993.

the committee, David Dodge, then the deputy minister of finance, reiterated the Department of Finance's position that the foreign affiliate rules reflected and were completely consistent with the government's tax policy objectives.[22] The committee made the following recommendations, among others:

- The Department of Finance should assess the merits of according exempt surplus status to foreign affiliates that operate in treaty jurisdictions that are, in fact, tax havens.
- The Department of Finance should complete the studies of the treatment of foreign-source income and foreign affiliates that it had earlier indicated it had undertaken[23] and develop specific amendments to the Act to protect the integrity of the tax base.
- Finance and the CRA should submit a report to the Public Accounts Committee on an annual basis commenting on the effectiveness of GAAR in thwarting tax-avoidance schemes used in connection with foreign affiliates.

Anyone who is familiar with the foreign affiliate rules will know that the rules have been under constant review for a long time. They have been the subject of repeated and continuing tweaking and technical amendment, even if the type of review that the auditor general and the Public Accounts Committee had recommended may not have taken place. Indeed, a currently pending package of amendments to the foreign affiliate rules is aimed at fixing some of the provisions that have been identified by the Department of Finance as susceptible to abuse or as likely to produce overly generous tax results. These amendments are not entirely technical in nature; many of them are substantive. However, despite the extensive changes to aspects of the foreign affiliate rules over the years, the basic system allowing repatriation, on an exempt basis, of active business earnings that arise in treaty jurisdictions and permitting passive income to be recharacterized as active in certain circumstances has remained largely intact since 1974, as a consequence of what must be assumed to be deliberate tax policy decisions. This fact is important to an understanding of the context of paragraph 95(6)(b).

Why the CRA Is Searching for a Supplement to GAAR

As we have seen, subsection 95(6) has existed in some form since the inception of the foreign affiliate regime. But only since the subsection was amended in 1995 has the CRA shown much interest in invoking it as an anti-avoidance rule of more general application than is suggested by its legislative history.

22 Ibid., issue no. 37, at 11-12. In particular, Mr. Dodge stated that the rules struck a reasonable balance between a number of complex, and in some cases competing, objectives. Further, they were "squarely within the international norms."

23 In that respect, the Department of Finance provided the Public Accounts Committee with a list of the amendments made to the FAPI rules since 1987.

Specifically, in recent years the CRA has made it clear that it believes that paragraph 95(6)(b) is capable of being applied in a variety of circumstances where a taxpayer has engaged in what the CRA considers to be abusive tax planning involving foreign corporations. The rule has been invoked by the CRA as the basis for denying the benefits of foreign affiliate status, even if that status has not been obtained by any artificial manipulation of share ownership, through options or otherwise. However, the CRA does not suggest that subsection 95(6) would or should be applied in every instance in which (on its view of the proper interpretation of the provision) the words could technically be said to fit; rather, its application will be selective and limited to those circumstances where the CRA considers that abusive tax avoidance has occurred. In other words, the CRA views subsection 95(6), and paragraph 95(6)(b) in particular, as a tool that is tantamount to a general anti-avoidance rule in the context of the foreign affiliate rules (and, as such, as supplementary to GAAR and perhaps a better tool than GAAR) in its efforts to combat tax avoidance that involves offshore structures.

A more detailed discussion of the CRA's evolving administrative practices and policies and our understanding of the current status of such practices is set out below.

It is perhaps understandable that the CRA is looking beyond the provisions of section 245 for tools to counter tax avoidance and, in doing so, is challenging the courts to stretch the words of certain specific anti-avoidance provisions to apply to facts and circumstances that are beyond their intended scope. Although the recent Supreme Court of Canada decisions in *Canada Trustco Mortgage Company v. Canada*[24] and *Mathew v. Canada (sub nom. Kaulius v. The Queen)*[25] have provided long-awaited guidance on the scope and interpretation of GAAR, and although some case law applying the Supreme Court's interpretive guidelines is now emerging from the Tax Court of Canada, the cases are somewhat uneven and their predictive value is uncertain.[26] There is little doubt that the CRA is not entirely satisfied with GAAR as its key weapon against tax avoidance. Nevertheless, in our view, that is no justification for the CRA's attempt to elevate subsection 95(6) to the status of an avoidance rule

24 2005 SCC 54; 200 5 DTC 5523.

25 2005 SCC 55; 2005 DTC 5538.

26 As of the time of writing, eight decisions of the Tax Court relating to GAAR have been released since the Supreme Court's decisions in *Canada Trustco* and *Kaulius*: *Evans v. The Queen*, 2005 DTC 1762 (TCC); *Univar Canada Ltd. v. The Queen*, 2005 DTC 1478 (TCC); *Overs v. The Queen*, 2006 DTC 2192 (TCC); *Desmarais v. The Queen*, 2006 DTC 2376 (TCC); *XCO Investments Ltd. et al. v. The Queen*, 2005 DTC 1731 (TCC); *Lipson v. The Queen*, 2006 DTC 2687 (TCC); *Ceco Operations Ltd. v. The Queen*, 2006 DTC 3006 (TCC); and *MIL Investments SA v. The Queen*, 2006 TCC 460. The Crown was successful at the Tax Court level in *Desmarais*, *XCO Investments*, *Lipson*, and *Ceco*, although it should be noted that *XCO Investments* was decided on the basis of section 103; the court found it unnecessary to invoke GAAR. However, some of the decisions are difficult to reconcile and the debate over how the Supreme Court's GAAR guidelines set out in *Canada Trustco* and *Kaulius* should be interpreted and applied is still in its infancy. What is clear is that the Supreme Court has signalled that the primary responsibility for determining whether GAAR should apply in a particular case lies with the Tax Court as finder of fact.

of general application in the foreign affiliate context. We believe that to the extent that the CRA's view is that the subsection can and should be so construed, that view is ill-founded.

As we were so recently reminded by the Supreme Court in *Canada Trustco*, "[t]here is no doubt today that all statutes, including the Act, must be interpreted in a textual, contextual and purposive way," and "[t]he provisions of the *Income Tax Act* must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently."[27] The CRA's interpretation of paragraph 95(6)(b) would not produce consistency, predictability, or fairness.

The Second-Tier or Indirect Finance Company Cases

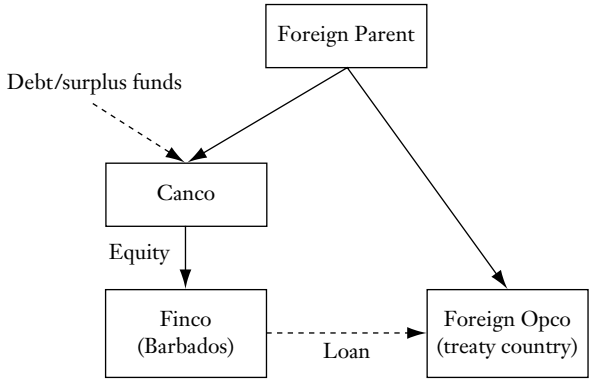
The recent controversy over the scope of paragraph 95(6)(b) began in earnest with certain offshore financing structures that were the subject of audit action by the CRA. Most of these transactions came under scrutiny in the early to mid-1990s. The two key components of the planning required, first, that interest income received by a wholly owned (foreign) subsidiary of a Canadian corporation be recharacterized under subparagraph 95(2)(a)(ii) as income from an active business, and, second, that dividends received by the Canadian corporation on the shares of the subsidiary be considered to be dividends received on shares of a foreign affiliate.

Although it does not seem a surprising conclusion that a wholly owned foreign subsidiary of a Canadian corporation should be a foreign affiliate of that Canadian corporation (and certainly no artificial manipulation of the share ownership of any corporation was undertaken in any of the planning steps), the CRA has now taken the view that even if such transactions are in technical compliance with the foreign affiliate rules in the Act, they constitute abusive tax avoidance. The CRA's initial case against these transactions was primarily based on the assertion that GAAR applied to redetermine the tax consequences of such arrangements. More recently, the CRA has also invoked the specific anti-avoidance provisions in subsection 95(6) in support of the reassessments, specifically to assert that the foreign subsidiary in question should not be regarded as a foreign affiliate of the Canadian parent corporation.

The transactions that have resulted in reassessments generally involved a Canadian corporation (Canco) that was part of a multinational group of companies controlled outside Canada. Canco either had surplus cash that could usefully be deployed to finance the operations of other group companies, or it had borrowing capacity. In a typical structure, Canco used surplus cash, proceeds of a new borrowing, or a combination of borrowed and non-borrowed funds to subscribe for shares of an offshore subsidiary resident in a low-tax treaty jurisdiction (typically Barbados). That entity (Finco) then made interest-bearing loans to related foreign entities within the multinational group. The related borrowers were residents of countries with which Canada had a tax treaty, and the borrowed funds were used in the borrower's active business. The end structure is depicted in figure 1.

27 *Canada Trustco*, supra note 24, at paragraphs 11 and 12.

FIGURE 1 Indirect Financing of a Foreign-Owned Corporation



These arrangements were sometimes referred to as "second-tier" or "indirect" financing structures because, although the direct use of the funds of the Canadian corporation (itself a subsidiary of a foreign parent in a multinational group) was to finance (through equity) its wholly owned foreign subsidiary, the indirect use of the funds was to finance sister entities. The CRA seemed to view this as key to its position that the planning was abusive; that is, if the parent in the multinational group had been a Canadian entity, the provision of financing (in reliance on the same foreign affiliate rules) that was purely downstream into foreign subsidiaries within the group would not have been viewed as offensive. As we discuss later in this article, the CRA continues to make this distinction when it assesses whether a structure is abusive tax avoidance. As far as we know, the CRA has not reassessed any similar transactions that involved a Canadian multinational group.

Subject to anti-avoidance concerns, it seemed evident that such arrangements, if properly implemented, were in technical (and substantive) compliance with the provisions of the Act. As already discussed, the Act contains a body of highly technical rules that govern the taxation of income of foreign affiliates of Canadian taxpayers and specific rules that operate to recharacterize what would otherwise be passive FAPI as active income if the income is derived from a related foreign corporation that incurred the relevant amount as an expense in earning its active income.

In the structure shown in figure 1, Finco earned passive income, in that all it received was interest income; however, the specific rules in the foreign affiliate provisions of the Act—in particular, the rules in subparagraph 95(2)(a)(ii)—operated to recharacterize this passive income as active because it was derived from loans made to related non-resident corporations resident in treaty countries that used the borrowed funds in their active businesses carried on in such countries. This recharacterization permitted the repatriation of the earnings of Finco to Canco as dividends out of exempt surplus that, although initially includible in Canco's income, were deductible in computing Canco's taxable income under the rules in section 113,

unless either GAAR or a specific anti-avoidance rule (such as that in subsection 95(6)) operated to change this result.

Arguably, the transactions skirted certain constructive dividend rules in the Act, under which a direct loan by Canco to a related entity would have attracted withholding tax under subsection 15(2) and paragraph 214(3)(a). Further, if Canco had made a direct loan to the related borrower from Finco, Canco would have reported interest income in Canada. However, this was a result that was specifically contemplated by the foreign affiliate rules. It was also, at the time, a result specifically contemplated by the provisions of section 15 that deal with constructive dividends resulting from loans made by Canadian corporations to non-resident shareholders or related non-resident parties.

The characterization of the interest earned by Finco as exempt earnings based on the borrower's use of the funds in an active business was simply a feature of the foreign affiliate regime that had been in place for many years (and that remains in place today, relatively unchanged). Certain other rules in the Act—most importantly, those in section 17 (direct and indirect loans to non-residents)—have since been changed in ways that render obsolete the type of planning involved in some of these cases; we will return to a discussion of those amendments later in the article. As a consequence of the amendments, many of the financing structures that would have attracted the CRA's scrutiny were subsequently unwound.

A number of the reassessments issued by the CRA in connection with second-tier financing structures were settled. Many of these settlements were agreed to because the taxpayers involved did not wish to incur the expense or publicity of litigation. In some cases, settlement was an attractive option because the basis for settlement did not involve a significant increase in overall tax liability, once offsetting credits in other jurisdictions were factored into the costs of settlement.

The cases in which the CRA has invoked subsection 95(6) and an appeal has been undertaken by the taxpayer are starting to work their way through the courts. One such case, *Univar Canada Ltd. v. The Queen*,[28] was recently decided in the taxpayer's favour by the Tax Court (and has not been appealed by the Crown). However, as discussed below, it is difficult to find much guidance in the *Univar* decision as to the proper scope of subsection 95(6). Although *Univar* may be taken to be a significant success for the taxpayer and, perhaps, as a general indication that the CRA is on shaky ground in attempting to use subsection 95(6) as a basis for attacking the structures, the case was highly fact-specific. The decision does not engage in a detailed analysis of the relevant provisions, and its predictive value in other fact situations thus seems low. It is therefore unlikely that the Crown's loss in this case will deter it from proceeding with the other cases that are nearing the hearing stage. In the meantime, the CRA's representatives also continue to state, both formally and informally, that the CRA believes that it has the ability to use subsection 95(6) as a tool against other planning that it considers abusive tax avoidance.

When the CRA first started auditing and assessing the second-tier financing transactions, its key argument was that GAAR should apply to allow it to ignore Finco,

28 Supra note 26.

and that Canco should be subject to tax on the same basis as if Canco had directly made the loans to the related borrowers. The CRA asserted, among other things, that there had been a misuse or abuse of subparagraph 95(2)(a)(ii); this assertion was based on its view that subparagraph 95(2)(a)(ii) should, as a policy matter, be available only when the related corporation to which the financing subsidiary loaned funds was a controlled foreign affiliate of Canco, and not when Canco itself was a subsidiary of a foreign parent corporation and the ultimate borrower was a sister company.

As a consequence, the CRA assessed Canco by adding to Canco's income the interest income earned by Finco. If the loans made by Finco to related foreign borrowers remained outstanding long enough that, if made directly, they would have attracted the application of subsection 15(2) (and paragraph 214(3)(a)), the CRA also assessed withholding tax.

Sometime around 2000 or 2001, there was a significant shift in the CRA's assessing approach to these transactions. As discussed in connection with the legislative history of subsection 95(6), a change was made to the wording of subsection 95(6) effective for taxation years commencing after 1994. It seems obvious that the change was noted by one or more CRA officials involved in the assessing actions being pursued in connection with the second-tier financing arrangements. The consequence was that the CRA concluded that where the transaction had been implemented in 1995 or later, the CRA's attack would be two-pronged—not only would GAAR be invoked but, through the use of the anti-avoidance rule in paragraph 95(6)(b), Finco's status as a foreign affiliate of Canco would be disputed. That is, according to the CRA, the perceived tax benefits associated with the financing arrangements meant that paragraph 95(6)(b) could be used to deny foreign affiliate status to Finco. Since that status was necessary for Finco's earnings to be repatriated as dividends out of exempt surplus that were free of Canadian tax, the CRA's alternative approach meant that when and if the earnings of Finco that were derived from interest on the loans to related-party borrowers were repatriated in the form of dividends, those dividends would be fully taxable to Canco.

The result was a flurry of activity in many of the cases already under way. New reassessments were issued in which subsection 95(6) was asserted to be an alternative basis, or even the principal basis, for the assessment. The resulting confusion was noted in the *Univar* case, where the history was described (by an obviously frustrated presiding judge) as follows:

> The Minister of National Revenue ("Minister") followed unusual assessing procedures in this matter. As set forth under REASSESSMENTS the Minister's first reassessment of six of the Appellant's taxation years, adding interest to its income, was based on section 245. The second reassessment, disallowing the subsection 113(1) dividend deduction, was based upon subsection 95(6) and, in the alternative, on section 245. Two other Notices of Reassessment were issued. One assessed a non-resident Part XIII tax for the Appellant's 1995 taxation year. The other assessed a penalty for one of the Appellant's three 1996 taxation years.[29]

29 Ibid., at paragraph 8.

An approach based primarily on subsection 95(6) arguably did not produce as beneficial a result for the fisc as an approach based on a successful GAAR argument: under the subsection 95(6) approach, the ability to tax the Finco earnings would be delayed until repatriation, whereas under the GAAR approach, the interest earned by Finco was asserted to be taxable in Canco's hands on an "as earned" basis. From a practical point of view, however, given the other changes to the Act that made such structures unsustainable, the fact was that many of the structures had been unwound and Finco's earnings had been repatriated. Further, it appears that the CRA may have concluded that its case based on subsection 95(6) might have a better prospect of success than a GAAR-based approach.

Section 17 Amendments Relevant to Indirect Financing Structures

As noted above, one of the arguments made by the CRA in its reassessments of the second-tier or indirect financing structures under GAAR was that the recharacterization provisions of subparagraph 95(2)(a)(ii) had been misused or abused in instances where Canco was a subsidiary of a foreign parent corporation and the financing subsidiary (Finco) had loaned the funds (on which interest was earned) to a corporation that was not controlled by Canco, but rather was simply a sister company controlled by the foreign parent corporation. The CRA argues, persistently, that subparagraph 95(2)(a)(ii) is intended to allow a Canadian multinational group to finance its foreign subsidiaries operating abroad through a foreign financing entity, and not to allow a Canadian subsidiary that is part of a foreign multinational group to finance the operations of related foreign companies (that are not controlled by the Canadian entity).

It is impossible to find evidence of such a policy in subparagraph 95(2)(a)(ii), either as it read at the time that the second-tier financing transactions were implemented, or as it currently reads. Even today, subparagraph 95(2)(a)(ii) allows the recharacterization, as active income, of interest earned by a foreign affiliate of a Canadian corporation (in respect of which the taxpayer has a qualifying interest throughout the year) that is derived from a loan to a non-resident corporation to which the particular affiliate and the Canadian corporation are related throughout the year, provided that the interest is deductible in determining the related non-resident corporation's earnings from an active business carried on outside Canada. For a Canadian corporation to have a qualifying interest in a foreign affiliate, it is only required to own shares representing at least 10 percent of the shares of the foreign affiliate on a votes-and-value basis.[30]

The Department of Finance amended the provisions of section 17 in a way that arguably gave effect to the CRA's tax policy objectives in regard to subparagraph 95(2)(a)(ii). However, the route by which those objectives were effectively achieved was circuitous.

30 Under pending amendments, it will not even be necessary for the taxpayer to have a "qualifying interest" in the foreign affiliate throughout the year; it will be sufficient if the foreign affiliate is "related" to the Canadian corporation throughout the year.

Subsection 17(1) deems a corporation resident in Canada to earn a prescribed rate of interest on loans or other amounts owing to it by a non-resident person where such indebtedness remains outstanding for more than one year. Until 1999, subsection 17(1) applied only if the loan was made directly by the corporation resident in Canada. Section 17 was amended in 1999 to extend the application of subsection 17(1) to certain indirect loans (for example, a loan from one non-resident corporation to another) that are facilitated by a loan or transfer of property by a corporation resident in Canada. To this end, subsection 17(2) provides that if a non-resident person is indebted to a person or partnership (other than a corporation resident in Canada), and if it is reasonable to conclude that the indebtedness arose because a corporation resident in Canada made a loan or transfer (other than an exempt loan or transfer), then the non-resident person is deemed to owe an amount equal to the indebtedness to the corporation resident in Canada. Subsection 17(15) defines an exempt loan to include a loan made by a Canadian-resident corporation at an arm's-length interest rate—that is, at an interest rate to which a lender and borrower, dealing at arm's length with each other at the time the loan was made, would have agreed.

When the Department of Finance released the initial version of the draft rules to amend section 17 to apply to indirect loans, the rules contained a specific exception from the indirect loan rule for indebtedness the interest on which was recharacterized as income from an active business under subparagraph 95(2)(a)(ii). This seems to be solid evidence that in the view of the Department of Finance, the amendments that it was proposing to section 17 did not have as their specific focus the types of second-tier or indirect financing structures that were the subject of the CRA's assessing action. In fact, this iteration of the provision obviously undercut the reassessments that the CRA was pursuing in relation to such transactions, because it seemed to indicate that from a policy perspective such transactions were expressly sanctioned, not only under subparagraph 95(2)(a)(ii) but also under the indirect loan provisions of subsection 17(2). In other words, the first iteration of the provision, which permitted an exception from the operation of the indirect interest rule in subsection 17(2) for amounts to which subparagraph 95(2)(a)(ii) applied, clearly compromised the CRA's GAAR challenge of the indirect financing transactions, because the challenge was premised in part on the basis that such transactions were contrary to the policy or object and spirit of subparagraph 95(2)(a)(ii).

It seems that this oversight was quickly identified by the CRA and brought to the attention of the Department of Finance, because the version of the rule that was ultimately enacted did not contain this exception. The exception from the application of subsection 17(2) that is found in subsection 17(3) is for indebtedness owed by a non-resident person that is a controlled foreign affiliate of the corporation resident in Canada. For this purpose, a special definition of "controlled foreign affiliate" in subsection 17(15) requires the borrower to be controlled by Canadian residents in order to be considered a controlled foreign affiliate of a taxpayer resident in Canada.

This exception thus achieves the CRA's objectives from a tax policy perspective, because it allows a Canadian corporation to use exactly the same financing structure used in the Finco structure described above (that is, Canco funds Finco with equity

and Finco makes a loan to a non-resident corporation), but only where the borrower is a controlled foreign affiliate of Canco under the modified definition. In other words, because of the limitation on the subsection 17(3) exception for financing structures in which both the offshore finance company and the end borrower are controlled directly or indirectly from Canada, the object of restricting access to subparagraph 95(2)(a)(ii) to financing subsidiaries that on-lend to corporations controlled by the Canadian entity that sources the funds is achieved, albeit circuitously. Presumably, a Canadian entity that funds an offshore financing company that on-lends to a related but not controlled foreign entity resident in and carrying on business in a designated treaty country should still be able (with appropriate structuring) to receive out of the exempt surplus of the financing company dividends that are sourced in interest paid by the ultimate borrower. In the meantime, however, the Canadian entity will have been required to report imputed interest on the indirect financing under subsection 17(1). If the ultimate borrower is not resident in a designated treaty country, or if the interest expense relates to a business carried on in a country other than a designated treaty country, double tax could result because the interest paid to the financing subsidiary can be repatriated only as a dividend out of taxable surplus.

The technical notes issued by the Department of Finance with the amendments made to section 17 in 1999 explain that although the indirect loan rules in subsections 17(2) and (3) apply only to taxation years beginning after 1999, "the general anti-avoidance rule[s] in section 245 of the Act will have application to avoidance transactions affecting earlier years."[31] The absence of any reference to the application of paragraph 95(6)(b) to such avoidance transactions is interesting, particularly in light of the CRA's comments in the draft *Income Tax Technical News*[32] (discussed in more detail below) with respect to transactions to which subsection 17(2) does not apply. Presumably, it reflects the fact that at the time of the amendments, the CRA had not yet identified, or at any rate had not settled on, paragraph 95(6)(b) as a possible basis for challenging such transactions.

THE UNIVAR DECISION

To date, *Univar*[33] is the only decided Canadian case that deals with the interpretation of paragraph 95(6)(b). Univar Canada was a Canadian-resident corporation that had approximately $12 million of retained earnings; that amount was likely to increase in future years. Univar's US parent had an outstanding loan receivable of $27 million from a European subsidiary. For many US and Canadian tax and non-tax reasons, Univar Canada capitalized a Barbados subsidiary with equity, using surplus

31 Canada, Department of Finance, *Revised Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, March 1999), clause 8.

32 Canada Revenue Agency, *Draft Income Tax Technical News*, "Paragraph 95(6)(b)," March 14, 2005 (unpublished) (hereinafter referred to as "draft ITTN").

33 *Univar*, supra note 26.

cash and borrowed funds. The Barbados subsidiary acquired the loan receivable from Univar Canada's US parent, financing the acquisition with its retained earnings and borrowed money. The transactions were thus close to, if not on all fours with, the Canco-Finco second-tier financing structures described earlier. It is important to remember that the Crown's case in *Univar* was initially only a GAAR case and that the argument based on paragraph 95(6)(b) was introduced after the first set of reassessments was issued. The applicability of both provisions was thus before the court.

As we have seen, for paragraph 95(6)(b) to apply to the shares of a foreign affiliate, the primary purpose of the acquisition of the shares must be to avoid, defer, or reduce tax otherwise payable under the Act. Similarly, for GAAR to apply, there must be an avoidance transaction—that is, a transaction whose primary purpose is to achieve a tax benefit that results from the avoidance transaction (or from the series of which it is a part).

The essence of the Crown's case in *Univar* was that paragraph 95(6)(b) (and section 245) applied because the primary purpose of the subject transactions, including the acquisition of the shares of the foreign affiliate (the Barbados subsidiary), was to allow Univar Canada to avoid Canadian tax that would otherwise have been payable if it had directly acquired the $27 million loan receivable. The court described the Crown's case on this point as follows:

> I underline what I have said above, namely that the Respondent's case, both with respect to paragraph 95(6)(*b*) and section 245 is built solely upon the hypothetical premise that the debt of UE to UC was purchased by Univar, not by Barbadosco.[34]

In the end, the Crown lost in *Univar* because the court rejected the Crown's case on this point. The court's conclusion, based in substantial part on the testimony of the key individual participants, was that the direct acquisition of the loan receivable by Univar Canada was not an alternative transaction to the actual transactions that Univar Canada had effected—in fact, the court found on the evidence that the hypothetical alternative transaction had never actually been considered as a possible course of action. Thus, in the court's view, the tax that might have been payable as a consequence of the alternative transaction (that never was) could not represent the tax that would otherwise have been payable (as required by paragraph 95(6)(b)), absent the actual transactions, or the tax that was avoided (as required by section 245), because of the actual transactions. Stated simply, the court concluded that in connection with the potential application of paragraph 95(6)(b), no tax that was otherwise payable had been avoided by the actual transactions.

Although the result was a welcome one from the taxpayer's point of view, the narrow manner in which the Crown framed its case on paragraph 95(6)(b)—focusing, as it did, on the hypothetical alternative transaction as the sole measure of the tax that had been avoided by the actual transactions, and the court's rejection of the

34 Ibid., at paragraph 38.

Crown's approach without much discussion or analysis—makes the relevance of the decision in other circumstances far from clear. Although the case seems of little assistance in analyzing the proper scope of paragraph 95(6)(b), we will return to a discussion of some of its possible implications below.

THE EVOLUTION OF THE CRA'S VIEWS ON THE SCOPE OF PARAGRAPH 95(6)(b)

Although the current focus on paragraph 95(6)(b) commenced in earnest with the CRA's assertion that the rule was properly invoked in second-tier financing structures, it is now clear that the CRA is also studying the possible application of subsection 95(6) in other cross-border financing arrangements in respect of which the foreign affiliate status of a non-Canadian entity is an important element. These initiatives are of concern because the CRA's stated view is that it can use paragraph 95(6)(b) as a form of discretionary anti-avoidance provision of general application in any case where the foreign affiliate status of a corporation has resulted in an apparent tax benefit or advantage. Since foreign affiliate status almost always results in some inherent tax advantage because of the overall structure of the foreign affiliate system, the danger of this approach, from the point of view of taxpayers and their advisers, is obvious. When can the definitional rules for determining the status of a foreign corporation in relation to another Canadian corporation—whether a foreign affiliate or not—be relied upon? CRA officials have suggested that whether or not paragraph 95(6)(b) will be invoked in a particular fact pattern depends on how "abusive" the CRA considers the tax planning to be. The examples that the CRA has offered for discussion, which are discussed at greater length below, suggest that a high degree of subjectivity is being brought to bear on whether particular planning strategies represent abusive tax avoidance.

Before its recent change in course, the CRA provided only limited guidance on its administrative interpretation of paragraph 95(6)(b). What guidance there was suggested that the CRA would interpret the provision in a manner consistent with its legislative history and the Department of Finance's technical notes. However, the value of this administrative guidance is somewhat moot in light of recent CRA positions.

In 1999,[35] the CRA commented on a fact situation in which the foreign affiliate status of a particular corporation in relation to a Canadian corporation was relevant to a determination of whether an individual taxpayer employed by the foreign entity was entitled to an overseas employment tax credit. The taxpayer argued that subsection 95(6) should be restricted in its scope to transactions that resulted in the reduction or avoidance of tax triggered by the rules in subdivision i of part I, division B—for example, the tax applicable to FAPI of a controlled foreign affiliate that was includible in the income of a Canadian resident. Since the tax benefit that was claimed had nothing to do with the overall purpose of the foreign affiliate rules, subsection 95(6)

35 CRA document no. 9903126, March 18, 1999.

should not apply. The CRA rejected this interpretation, noting that section 113 was outside subdivision i, but that it must still have been Parliament's intention that subsection 95(6) could apply where, "for example, preferred shares of a foreign corporation were issued to a corporation resident in Canada so that corporation would be able to make a deduction under section 113 with respect to dividends paid to that corporation on the common shares of the foreign corporation and the holding in the common shares was not sufficient to create foreign affiliate status."[36]

The facts that resulted in the request for the interpretation are not clear, but the CRA's response suggests that a nominal or temporary share investment was likely made in order to permit the foreign employer to technically satisfy the criteria for foreign affiliate status (to allow an employee of that corporation to qualify for the particular tax credit). In other words, this interpretation seems consistent with the view of paragraph 95(6)(b) as primarily concerned with artificial or transitory share investments designed to permit a taxpayer to achieve a particular tax benefit by technically satisfying the bright-line test in the foreign affiliate definition.

In 2001,[37] the CRA suggested that unless the tax reduction or avoidance was attributable to foreign affiliate status, subsection 95(6) should not be applied. The fact situation involved the transfer by a US parent company to its Canadian subsidiary of the shares of a French subsidiary (having operating losses), followed by an amalgamation under French law of the loss subsidiary with a French partnership held by related Canadian corporations. The overall purpose of the transactions appears to have been to give the Canadian members of the French partnership access to the losses of the subsidiary. A CRA District Office asked the Rulings Directorate to consider whether, in light of the overall tax motivation of the transactions, subsection 95(6) should be applied. It is not entirely clear from the response what tax consequences the District Office thought might result if paragraph 95(6)(b) applied to deem the shares of the French loss company not to have been acquired or disposed of.

In its response, the Rulings Directorate stated that although it could be argued that the principal purpose of the acquisition of the French loss subsidiary was to enable the related Canadian companies to access the subsidiary's operating losses and thus reduce the income tax they otherwise would have had to pay, the tax reduction or avoidance did not result from the foreign affiliate status of the loss subsidiary. Rather, it resulted from the amalgamation or "fusion par absorption" transaction in which the loss subsidiary was effectively converted into, or merged, with an entity considered for Canadian purposes to be a partnership. Therefore, subsection 95(6) did not apply to either the acquisition or the disposition of the shares of the loss corporation.

Both of these opinions seem to us to be sensible interpretations of paragraph 95(6)(b) that may be defended as being consistent with a textual, contextual, and purposive reading of the rule. Interestingly, in another interpretation given in 2001,[38] the CRA

36 Ibid.

37 CRA document no. 2000-0024647, February 9, 2001.

38 CRA document no. 2001-0079985, November 13, 2001

considered an investment by a Canadian corporation (that was in turn a subsidiary of a US-based financial institution) in preferred shares of a US sister company. The interpretation focused only on whether the shares of the US sister company could be considered to have been acquired "in the ordinary course" of the Canadian holder's business. Because the terms of the shares made them term preferred shares, and because the investing corporation was, by virtue of being controlled by a financial institution, a "specified financial institution" for the purposes of the Act, the issue was whether the provisions of subsection 258(3) should apply to treat the dividends on the shares as interest to the holder. If subsection 258(3) deemed the dividends to be interest, no deduction would be available in respect of such dividends under section 113. Although the CRA expressed concern with the (apparent) overall tax motivation of the investment and suggested that subsection 258(3) should perhaps apply, there is not even a hint of a suggestion that the provisions of paragraph 95(6)(b) might come into play as an alternative basis for denying access to the deduction in section 113.

In light of this record of administrative positions and pronouncements, the CRA's most recent views concerning the breadth and scope of paragraph 95(6)(b) and its potential role as a form of discretionary general anti-avoidance rule in the foreign affiliate context would have come as a surprise to anyone who was not directly involved with CRA assessments of second-tier financing structures.

Rumours that the CRA was considering invoking paragraph 95(6)(b) in "plain vanilla" structures began to circulate in the tax community several years ago. In particular, there were suggestions that the CRA was considering invoking the rule in a financing structure—widely known as a "tower structure"—that is in common use by Canadian-based multinationals to finance their foreign (particularly US-based) operations. Essentially, the tower structure is a double-dip financing structure in which interest deductions are, at least potentially, available in two jurisdictions.

In general terms, on the basis of comments that CRA officials had made in the context of the second-tier financing structures (and, indeed, on actual rulings granted by the CRA), it was thought that the use of the foreign affiliate rules by a Canadian-based multinational group to tax-effectively finance its foreign operations was not abusive, even if such arrangements resulted in deductible interest expense in more than one jurisdiction (a double dip). The rumour that the CRA was now considering invoking paragraph 95(6)(b) in a double-dip structure, or in some double-dip structures, was troubling.

Unfortunately, the rumour proved to have some basis in fact. In late 2004 and through 2005, representatives of the CRA held several private meetings with interest groups in the tax community. One such meeting was held with representatives of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants; another was held with representatives of the Tax Executives Institute. The CRA also sent representatives to speak in various public forums, such as those sponsored by the Canadian Tax Foundation and the International Fiscal Association. In these discussions, the CRA offered examples of hypothetical situations in which the CRA thought it might be appropriate to apply paragraph 95(6)(b). The CRA also began work on the draft ITTN, setting out various hypothetical situations

and providing commentary on whether paragraph 95(6)(b) ought to be applied to these situations. The CRA arranged for limited circulation of the draft ITTN to obtain comments. Although the draft ITTN was circulated on a confidential basis, its contents have become generally known in the tax community, and the examples and analysis set out therein have been openly discussed by various CRA officials.

THE DRAFT INCOME TAX TECHNICAL NEWS

Although we will not review all of the examples in the draft ITTN, we will attempt to give an indication of the direction in which the CRA appears to be heading, as indicated by the draft ITTN and other commentary, and to illustrate why we believe that the CRA's approach is fundamentally flawed as a matter of statutory interpretation.

The CRA met with representatives of the Tax Executives Institute in December 2005 and responded as follows to a question concerning the draft ITTN's current status:

> The CRA continues to view subsection 95(6) as having broad application. Since the 2004 Canadian Tax Foundation Conference, the CRA has been preparing some examples of certain structures where it considers that paragraph 95(6)(b) will apply, and of structures where it considers that paragraph 95(6)(b) will not apply. The CRA intends to publish the examples in an Income Tax Technical News at some future date. Completion of the ITTN has been postponed while we consider the recent Tax Court of Canada decision in *Univar Canada Ltd. v. The Queen*, and pending the outcome of several other appeals involving foreign financing structures that are before the court.[39]

Obviously, the CRA does not think that *Univar* dealt with paragraph 95(6)(b) in a sufficiently substantive way to be helpful in the CRA's efforts to finalize the ITTN.

In the draft ITTN, several points seem, on a proper reading of paragraph 95(6)(b), to be valid. One is that the principal purpose of a share acquisition (or disposition) is to be determined objectively from the facts and circumstances surrounding the particular transaction. For the reasons discussed below, we agree with the CRA's conclusion that the purpose test in paragraph 95(6)(b) would be construed by a court as an objective one. The other point that is difficult to argue with is that on the wording of paragraph 95(6)(b), the tax benefit (that is, the avoidance, reduction, or deferral of tax referred to in the provision) need not be enjoyed by the person who acquires or disposes of the shares; it is sufficient that the tax benefit be enjoyed by any person.

Once the CRA moves beyond these two principles, however, the discussion becomes problematic. There are two key aspects of the CRA's approach with which we have great difficulty and on which we focus later in this article. The first is that in the CRA's view there is a "series" concept that may be read into paragraph 95(6)(b),

39 CRA document 2005-0158741C6, November 23, 2005. A comment to much the same effect may be found in CRA document no. 2005-0155331E5, December 5, 2005.

despite the clear absence of any wording to this effect. Thus, we find the following statement in the draft ITTN:

> A particular acquisition or disposition that is part of a series of transactions where the series is carried out principally for a purpose other than to permit a person to avoid, reduce or defer the payment of tax or any other amount may nevertheless be determined to have been carried out principally for the purpose of creating such a tax advantage. However, where it can be determined from all the circumstances that an entire series of transactions that includes the acquisition or disposition is carried out principally to permit a person to obtain a tax advantage, then the acquisition or disposition may be considered to have been carried out for that same purpose.[40]

The second problematic aspect is the CRA's obvious belief that the provision is a discretionary one that it can choose to apply (or not), depending on whether the CRA considers the tax planning abusive, despite the lack of any control on the exercise of that discretion (such as the "misuse or abuse" test in GAAR). In the draft ITTN, the CRA states that

> [t]he words of paragraph 95(6)(b) are broad and could be considered to apply to a wide range of transactions. However, its application will be restricted to those cases where the policy intent of one or more provisions of the Act is otherwise frustrated or circumvented. In order to ensure that the rule is applied only in those circumstances and in a consistent manner, all proposed reassessments involving paragraph 95(6)(b) will be reviewed by the Canada Revenue Agency in Headquarters.[41]

Several examples from the draft ITTN illustrate the points made above and suggest that the CRA has grand plans for paragraph 95(6)(b). In effect, the draft ITTN signals that the CRA views paragraph 95(6)(b) as a general anti-avoidance provision—like subsection 245(2) but without its statutory restrictions (notably, subsection 245(4)). Nevertheless, to demonstrate its restraint and to assuage the concerns of taxpayers and their advisers, the CRA effectively confirms that it will apply paragraph 95(6)(b) as if it had a counterpart to subsection 245(4), which limits the application of subsection 245(2) to those circumstances where there has been a misuse of a provision of the Act or an abuse of the provisions of the Act read as a whole.[42]

The first example given in the draft ITTN is referred to as a "classic double dip." A Canadian multinational corporation, Canco, owns all of the shares of a foreign affiliate operating company, FA Opco, that is resident in and carries on an active business in a treaty country. FA Opco needs financing for use in its active business. Canco incorporates Finco as a wholly owned subsidiary in a low-tax treaty jurisdiction. Canco borrows from a third-party lender and uses the funds to subscribe for

40 Draft ITTN, supra note 32, under "Principal Purpose."

41 Ibid., at second introductory paragraph.

42 Ibid.

shares of Finco. Finco lends the funds, at interest, to FA Opco. Assuming that Finco is regarded as a foreign affiliate of Canco, the interest earned by Finco on the loan to FA Opco is recharacterized as active income under subparagraph 95(2)(a)(ii), and dividends from Finco, although initially includible in Canco's income, are deductible in computing taxable income. This structure is illustrated in figure 2.

Notwithstanding that, as acknowledged in the example, "it can be inferred that the shares of Finco were acquired principally in order to permit the reduction of Part I taxes that would otherwise have been payable by Canco had it made the loan directly to FA Opco,"[43] the CRA states that it will not apply paragraph 95(6)(b):

> At an appearance before the Standing Committee on Public Accounts in 1992, the Deputy Minister of the Department of Finance announced that this structure enhances the competitiveness of Canadian multi-nationals abroad and is not offensive in policy terms. Canco participates fully in the growth in the value of FA Opco through its investment in the common shares of FA Opco. Since the arrangement is not offensive in policy terms, the CRA will not apply paragraph 95(6)(b) of the Act.[44]

The second example, illustrated in figure 3, results in exactly the same end structure as the classic double dip structure, and this is expressly acknowledged in the commentary. In this example, FA Opco has previously borrowed funds for use in its business. Canco assumes the FA Opco debt in exchange for an interest-bearing note from FA Opco and then incorporates Finco and contributes the interest-bearing debt owing to it by FA Opco to Finco for shares of Finco.

The CRA states:

> The 2002 Report of the Auditor General and the 1997 report of the Technical Committee on Business Taxation were both concerned about debt financing being shifted into Canada from other countries, which they felt resulted in an erosion of the Canadian tax base. Although the final structure in this example is identical to the "Classic Double Dip" described in Example 1, the process by which it was achieved is offensive in policy terms. The group has imported existing debt into Canada principally to achieve a tax advantage.[45]

Accordingly, the CRA concludes that the acquisition of Finco's shares by Canco should be disregarded as a consequence of the application of paragraph 95(6)(b). Finco will not be considered a foreign affiliate of Canco, and no deduction will be allowed under section 113 in respect of dividends on the Finco shares.

The third example is a tower structure, which is a variation on a classic double dip in which more layers of hybrid or reverse hybrid entities are inserted (primarily to meet US objectives). In the CRA's example, the borrowing originates in Canada—

43 Ibid., under "Classic Double Dip—Interpretation."

44 Ibid.

45 Ibid., under "Debt Importation—Interpretation."

FIGURE 2 Classic Double Dip

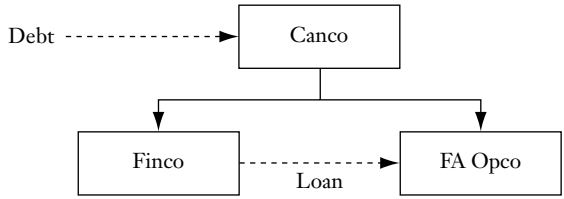
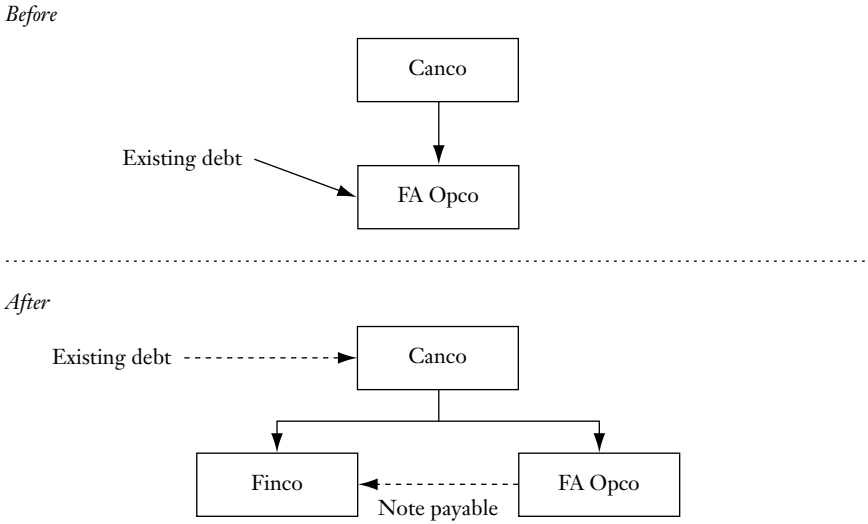


FIGURE 3 Debt Importation



that is, there is no pre-existing borrowing by FA Opco that is refinanced in the transactions. Not unexpectedly, the CRA states that the structure is not offensive in policy terms and that it will not apply paragraph 95(6)(b). Presumably, however, to be consistent with the second example, if there was pre-existing debt in the foreign jurisdiction that was refinanced through the implementation of a tower that was subsequently put in place, the CRA would say that paragraph 95(6)(b) applied.

The fourth example is, essentially, the indirect or second-tier financing structure that is already under attack, as discussed earlier. Canco is a subsidiary of Foreign Parent. Canco forms Finco and capitalizes Finco with funds borrowed by Canco. Finco makes loans to related Foreign Opcos that are sister corporations of Canco. Despite the fact that the structures depend on the application of exactly the same rules in the foreign affiliate provisions that apply in the classic double dip example, the CRA states that "the structure does not enhance Canco's competitiveness abroad" because Canco is a subsidiary of Foreign Parent and the structure does not result in any ability of Canco to participate in the growth in the value of Foreign Opco. The commentary

notes that amendments to section 17 generally now preclude such planning, and that if the rules in section 17 apply to impute interest income to Canco on the loan from Finco to Foreign Opco, paragraph 95(6)(b) will not be applied; however, for situations that existed prior to the coming into force of the amendments to section 17, the CRA will apply paragraph 95(6)(b) to deny foreign affiliate status to Finco.

The next example is characterized as "indirect financing with preferred shares." Again, Canco is a subsidiary of Foreign Parent, which also owns Foreign Opco. Through several layers, Canco uses borrowed funds to acquire preferred shares of Foreign Opco on which dividends will be received that exceed Canco's borrowing costs. The CRA states that because Canco has only a preferred share investment in Foreign Opco, the structure does not enhance the competitiveness of any Canadian corporation, and the share investments in the structure in entities that would otherwise be foreign affiliates of Canco will be deemed not to have taken place as a result of the application of paragraph 95(6)(b). The result is that dividends flowing back to Canco will not qualify for deduction under section 113.

The foregoing examples might all be characterized as financing structures that the CRA does or does not consider offensive, based on an apparent policy that it largely finds in remarks made by the deputy minister of finance in 1992.

The draft ITTN contains several other examples of planning to facilitate the sale of shares of a foreign affiliate that we will not review in this article.

At the 2005 IFA presentation, CRA officials commented on several other examples not included in the draft ITTN. One of these involved the use of what is commonly referred to as a "mixer" foreign holding corporation, which is established to hold the shares of several foreign affiliates of a Canadian taxpayer and (subject to paragraph 95(6)(b)) permits the mixing of low-tax and high-tax foreign earnings from a country that is not a designated treaty country. The CRA's informal remarks suggested that a distinction might be made between a structure where a holding company was in place from the outset and a subsequently implemented holding company structure. In more recent commentary, however,[46] the CRA indicates that the timing of the establishment of the mixer structure is not relevant, nor should foreign tax considerations be relevant in determining the principal purpose of the share acquisition.

In the same commentary, the CRA responded to a question concerning the potential application of subsection 95(6) to the acquisition of a share investment by a Canadian subsidiary (Canco), a subsidiary of Foreignco, in shares of USco, then a subsidiary of Foreignco. The shares were described as having a preferential dividend but some "upside potential" in certain circumstances (that is, certain common-share-like features). The CRA's response was as follows:

> We generally would accept that the acquisition of common shares in a corporation engaged in an active business would be made principally to earn a return in the form of dividends and growth in the value of the shares. If Canco acquired shares other than

46 CRA document 2005-0155331E5, December 5, 2005.

common shares of USco, the facts and circumstances would need to be examined to assess whether the principal purpose of the acquisition was to avoid, reduce or defer taxes otherwise payable by either Canco or Foreignco.[47]

It is evident from the draft ITTN and the other recent commentary that the CRA accords paragraph 95(6)(b) an interpretation that gives the provision a broad application. The CRA has concluded, presumably on the basis of a textual, contextual, and purposive analysis, that paragraph 95(6)(b) permits any acquisition of shares of a foreign affiliate to be ignored when the acquisition is part of a series of transactions that "is carried out principally to permit a person to obtain a tax advantage."[48] The CRA's premise is that the principal tax purpose of the series imbues each transaction in the series, including the acquisition of shares, with that purpose. In a typical example considered in the draft ITTN, the CRA treats an interest deduction that results from a series of transactions as the principal purpose of the series and concludes that even if the purpose of an acquisition of shares might be to earn a return on the shares as an investment, the primary purpose of the series becomes the primary purpose of the share acquisition. Notwithstanding that the CRA believes that this is the proper interpretation of paragraph 95(6)(b)—with the result that many foreign affiliate share acquisitions should be ignored under that provision—the draft ITTN reflects an attempt by the CRA to limit the application of the provision as a matter of tax administration.

In the draft ITTN, the CRA proposes that paragraph 95(6)(b) not be applied to ignore a share acquisition where the acquisition or, more importantly, the series of transactions of which it is a part produces a result that is consistent with what the CRA perceives to be the overarching tax policy objective of the foreign affiliate rules—to foster "Canadian competitiveness and growth." From the examples and comments set out in the draft ITTN, it seems clear that the CRA has discerned a policy that a foreign corporation should not be considered a foreign affiliate of a Canadian corporation if (among other things) the Canadian corporation's direct or indirect investment in the foreign corporation results in future growth accruing not to the benefit of the Canadian corporation but to the benefit of a foreign parent company. That is, unless the Canadian corporation participates fully in the growth in the value of the foreign corporation whose operations are financed by the Canadian corporation, the tax policy of enhancing the competitiveness of Canadian multinationals abroad is not furthered.

If the share acquisition or the series produces a result that frustrates, or that does not further, that tax policy objective, the acquisition will be ignored under paragraph 95(6)(b). Given the bright-line test prescribed by the foreign affiliate definition, and the detailed and specific nature of the foreign affiliate rules in general, it is difficult to see how the CRA's approach in the draft ITTN can be supported on a textual or contextual analysis of the foreign affiliate rules, let alone a purposive one. In fact,

47 Ibid.

48 Draft ITTN, supra note 32, under "Principal Purpose."

as is evident from the examples in the draft ITTN, the circumstances in which, according to the CRA, a particular share acquisition should be ignored as a consequence of paragraph 95(6)(b) are difficult to distinguish from those in which a share acquisition should be respected. There seems to be no real support for making these distinctions in the foreign affiliate provisions of the Act, and the CRA's approach produces results that run counter to the basic principle endorsed by the Canadian courts that, in general, the rules in the Act should be applied consistently to different taxpayers.

More questionable, in our view, is the interpretation of paragraph 95(6)(b) that underlies the draft ITTN. While the CRA's promised restraint in limiting what it perceives to be the broad application of paragraph 95(6)(b) is laudable, it is unnecessary and misses the point, which is that the CRA's interpretation of the paragraph is seriously flawed. But even if it could be established that the CRA's reading of the provision is reasonable on a textual and contextual analysis (which, for the reasons that we discuss below, we do not believe to be the case), it is not the only reasonable interpretation. We believe that our interpretation, set out in the sections that follow, is the reasonable and proper one.

To resolve the uncertainty about which of two reasonable interpretations should prevail, a purposive analysis must be undertaken to produce an interpretation that is harmonious with the other provisions of the Act—in particular, the foreign affiliate rules. We believe that there is no purposive analysis that would compel one to conclude that the intended result of paragraph 95(6)(b) is that an acquisition of the shares of a foreign affiliate may be ignored for the purposes of the foreign affiliate rules, notwithstanding that the acquisition is an investment that is reasonably expected to generate substantial dividends or long-term capital appreciation.

In our view, if paragraph 95(6)(b) is accorded a proper interpretation based on a textual, contextual, and purposive analysis, there is no need for the draft ITTN, or for the CRA to contrive a dubious means of limiting the scope of the provision. Properly interpreted, the provision limits itself and is relatively simple and straightforward.

DETAILED ANALYSIS OF PARAGRAPH 95(6)(b) AND A SUGGESTED APPROACH

Our objective in writing this article is to articulate the reasons why we believe that if paragraph 95(6)(b) is given a textual, contextual, and purposive interpretation, it cannot assume the role that the CRA would like it to perform. It is worth setting out again the portion of subsection 95(6) that is relevant to the current debate:

> 95(6) For the purposes of this subdivision (other than section 90) . . .
>
> (b) where a person . . . acquires . . . shares of the capital stock of a corporation . . . , either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition . . . is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, that acquisition . . . is deemed not to have taken place, and where the shares . . . were unissued by the corporation . . . immediately before the acquisition, those shares . . . are deemed not to have been issued.

The controversy over the correct approach to the interpretation of a provision in a taxing statute has raged for many years, but for the present the relevant principles do not seem to be in much doubt (although their application in practice may not be as clear). While the recent decisions of the Supreme Court of Canada in *Canada Trustco*[49] and *Kaulius*[50] dealt primarily with GAAR, the court in *Canada Trustco* made certain observations concerning the correct approach to interpreting the provisions of the Act. The court stated that there was "no doubt" that all statutes, including the Act, must be interpreted in a textual, contextual, and purposive way. That is, to the extent that the *Duke of Westminster*[51] stood for the proposition that the Act should be read literally, it no longer represented good law in Canada. Instead, the court confirmed that the overarching principle is that "[t]he interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole."[52]

It seems quite clear, however, that there may be instances in which the three subapproaches embodied in this rule are not internally harmonious and more weight must be given to one approach than to another. That is, the court acknowledged that there could be circumstances where a textual reading and a purposive analysis might give rise to different interpretations. In these cases, as the court put it, "the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation" in furtherance of the need to interpret the Act in such a way as to "achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently."[53] The court cited with approval its decision in *65302 British Columbia*:[54]

> It would introduce intolerable uncertainty into the *Income Tax Act* if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and purpose of the provision.[55]

Further, the court stated:

> A proper approach to the wording of the provisions of the *Income Tax Act* together with the relevant factual context of a given case achieve balance between the need to

49 Supra note 24.

50 Supra note 25.

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

52 *Canada Trustco*, supra note 24, at paragraph 10.

53 Ibid., at paragraphs 11 and 12.

54 *65302 British Columbia Limited v. The Queen*, [1999] 3 SCR 804, at paragraph 51, per Iacobucci J, quoting Peter W. Hogg and Joanne E. Magee, *Principles of Canadian Income Tax Law*, 2d ed. (Toronto: Carswell, 1997), 475-76.

55 *Canada Trustco*, supra note 24, at paragraph 12. Further, at paragraph 13, with specific reference to GAAR, the court noted, "To the extent that the GAAR constitutes a 'provision to the contrary' as discussed in *Shell* (at paragraph 45), the *Duke of Westminster* principle and the emphasis on textual interpretation may be attenuated."

> address abusive tax avoidance while preserving certainty, predictability and fairness in tax law so that taxpayers may manage their affairs accordingly. Parliament intends taxpayers to take full advantage of the provisions of the Act that confer tax benefits.[56]

The question of whether Parliament, in enacting a provision, intended to create a tax benefit for some category of persons, is not, in the usual case, a very difficult one to answer. However, determining who is in that category and is intended to qualify for that benefit may be more elusive. We believe, however, that in the foreign affiliate context, it is difficult (if not impossible) to conclude that a particular Canadian corporation that makes a substantial, long-term and (net) profitable investment in a related non-resident entity at a level that results in that entity being a "foreign affiliate" of the Canadian corporation, as that term is defined in the relevant provisions, is not entitled to the tax benefits that result from that investment being considered to be an investment in a foreign affiliate.

Further, we believe that whether paragraph 95(6)(b) is given a textual, contextual, or purposive reading, it cannot be given the meaning that the CRA would like to ascribe to it. In the context of a transaction or a series of transactions that includes the acquisition of shares of a non-resident corporation by a person or partnership, we believe that the question is whether the principal purpose of the acquisition of the shares, and not the purpose of the series of transactions of which the share acquisition may form a part, is to avoid, reduce, or defer tax otherwise payable under the Act. As we argue below, unlike GAAR, which may render a transaction an avoidance transaction if it is part of a "series of transactions or events" that gave rise to a tax benefit, paragraph 95(6)(b) does not direct that the tax benefit be identified as having resulted from a series of transactions of which the share acquisition was a part; we believe that the words in paragraph 95(6)(b) require that the tax benefit must flow from the share acquisition (or disposition) itself, and that obtaining the tax benefit must be the principal purpose of the share acquisition or disposition.

We also believe that the CRA's approach to paragraph 95(6)(b) as a discretionary anti-avoidance rule that will be applied only to deny tax benefits that result from abusive transactions is fundamentally flawed. As we argue below, the absence of any language that suggests that a misuse or abuse test should be read into the provision is, in our view, one of the most compelling arguments for a narrow construction of the provision and its restriction to the (we believe obvious) mischief at which it was aimed—that is, manipulation of share ownership to meet or fail the relevant tests for foreign affiliate, controlled foreign affiliate, or related-corporation status.

The Purpose Test: Objective or Subjective?

Before dealing with the detailed reasons for our submission that a textual, contextual, and purposive approach to the interpretation of paragraph 95(6)(b) shows the CRA's interpretation to be without foundation, at least on the two key points that are

56 Ibid., at paragraph 61.

the focus of this article, it is useful to make a preliminary point about the nature of the purpose test contemplated in subsection 95(6). We believe that the jurisprudence makes it clear that a purpose test that is embodied in a provision of the Act normally is an objective, not a subjective, test.[57] The issue was addressed by the Supreme Court in *Canada Trustco* in the context of GAAR. The purpose test used in subsection 245(3) that applies to determine whether a transaction is an avoidance transaction provides that an avoidance transaction is a transaction (or is part of a series of transactions) that results in a tax benefit "unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit." On the nature of the purpose test, the court stated:

> While the inquiry proceeds on the premise that both tax and non-tax purposes can be identified, these can be intertwined in the particular circumstances of the transaction at issue. It is not helpful to speak of the threshold imposed by s. 245(3) as high or low. The words of the section simply contemplate an *objective assessment* of the relevant importance of the driving forces of the transaction.
>
> Again, this is a factual inquiry. The taxpayer cannot avoid the application of the GAAR by merely stating that the transaction was undertaken or arranged primarily for a non-tax purpose. The Tax Court judge must weigh the evidence to determine whether it is reasonable to conclude that the transaction was not undertaken or arranged primarily for a non-tax purpose. The determination invokes reasonableness, suggesting that the possibility of different interpretations of the events must *be objectively considered*.[58]

Only in rare instances has a court held that a purpose test described in words similar to those used in paragraph 95(6)(b) should be construed otherwise than as an objective test. In *The Queen v. Placer Dome Inc.*,[59] the Federal Court of Appeal held that the purpose test in subsection 55(2) was subjective. However, to arrive at this conclusion, the court first acknowledged that determining the nature of a purpose test—that is, whether it is objective or subjective—is always a matter of considering the test in its particular context. In general, subsection 55(2) applies when a taxable dividend is received as part of a transaction or event or a series of transactions or events one of the purposes of which, or, in the case of a deemed dividend under subsection 84(3), one of the results of which, is to effect a significant reduction in a capital gain that would have been realized but for the taxable dividend. Thus, by its terms, subsection 55(2) provides both a purpose test and, in one circumstance, a results test. After noting that a results test was inherently objective in nature, the court found that

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57 For a persuasive case to the contrary, see Robert Couzin, "Subsection 245(3): A Framework," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 4:1-15.

58 *Canada Trustco*, supra note 24, at paragraphs 28-29 (emphasis added).

59 96 DTC 6562 (FCA).

> it is clear that the use of the term "purpose" in one context and "result" in another requires that a different meaning be attributed to each that is consistent with their use and context within subsection 55(2).[60]

As a consequence, the court found that the "purpose" test in subsection 55(2) should be construed as a subjective, not an objective, test.

Our belief is that the purpose test in paragraph 95(6)(b), which is worded similarly to that in subsection 245(3), would be found to be an objective test. In addition to the Canadian jurisprudence, case law in other Commonwealth jurisdictions supports the conclusion that the normal interpretation of a purpose test, phrased similarly to that in paragraph 95(6)(b), is to construe it as an objective test. See, for example, *Newton v. Commissioner of Taxation*,[61] *Ashton v. IRC*,[62] and *Magna Alloys and Research Property Ltd. v. Federal Commissioner of Taxation*.[63]

The Textual Approach

We do not think that there is a significant difference between the Supreme Court's "textual" approach in the recent GAAR cases and what we understand as the "plain meaning" approach. In a number of decisions leading up to the recent GAAR decisions, the court had endorsed the plain meaning approach to interpreting the provisions of the Act. The following statement in *Will-Kare Paving & Contracting Limited v. The Queen*[64] will be familiar:

> This Court has frequently endorsed the "plain meaning" rule of interpretation in relation to the Act. A recent instance is *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, *per* McLachlin J., as she then was, for the Court, at para. 40:
>
> > Where the provision at issue is clear and unambiguous, its terms must simply be applied.[65]

In *Canada Trustco*, one finds the following statement:

> When the words of a provision are precise and unequivocal, the ordinary meaning of the words play[s] a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.[66]

60 Ibid., at 6567.

61 [1958] AC 450 (PC).

62 [1975] 1 WLR 1615 (PC).

63 (1980), 33 ALR 213 (Full FC).

64 2000 DTC 6467 (SCC).

65 Ibid., at paragraph 49.

66 *Canada Trustco*, supra note 24, at paragraph 10.

Thus, "ordinary meaning" and "plain meaning" seem to be equated, and the cases seem consistent on the point that if the words are "precise and unequivocal" (which seems no different from "clear and unambiguous"), that ordinary meaning either must be "simply applied" or, in any event, is "dominant" and should govern unless the words also support a different "reasonable" reading.

In the even more recent decision of the Supreme Court in *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*,[67] the court stated, by way of further explication of what had been said in *Canada Trustco* in regard to the proper approach to interpretation of the Act, that

> [t]he interpretive approach is . . . informed by the level of precision and clarity with which a taxing provision is drafted. Where such a provision admits of no ambiguity in its meaning or in its application to the facts, it must simply be applied. Reference to the purpose of the provision "cannot be used to create an unexpressed exception to clear language." . . . Where . . . the provision admits of more than one reasonable interpretation, greater emphasis must be placed on the context, scheme and purpose of the Act. Thus, legislative purpose may not be used to supplant clear statutory language, but to arrive at the most plausible interpretation of an ambiguous statutory provision.[68]

It is clear from the CRA's comments in the draft ITTN and elsewhere that the CRA believes that it is possible to take into account the overall effect of a series of transactions of which the acquisition of the shares of a foreign affiliate is a part in determining whether the purpose test in paragraph 95(6)(b) is met. In other words, the CRA appears to think that the words "the principal purpose for the [share] acquisition . . . is to permit a person to avoid, reduce or defer the payment of tax . . . otherwise payable" should be read as equivalent to "the principal purpose for the [share] acquisition *or any series of transactions of which the share acquisition is a part* . . . is to permit a person to avoid, reduce or defer the payment of tax . . . otherwise payable."

If paragraph 95(6)(b) is given a plain reading, our view is that it is clear that the only relevant purpose is the purpose of the acquisition of the shares and not the purpose of something else, such as the series of transactions that includes the acquisition of the shares. Further, it is also clear that the tax benefit (that is, the avoidance, reduction, or deferral of the tax otherwise payable) must be the result of the share acquisition, and not of some other transaction in the series of transactions of which the share acquisition is a part. To read the provision otherwise means that the consequences of the application of the rule (ignoring the share acquisition or disposition) will not ensure the denial of the tax benefit that may be the ultimate objective of the series of transactions of which the share acquisition is a part. Paragraph 95(6)(b) expressly provides that where there is an acquisition of shares, the provision will apply

67 2006 SCC 20.

68 Ibid., at paragraph 23.

if the principal purpose of the acquisition is to permit a person to avoid or reduce tax that would otherwise be payable under the Act. It is the share acquisition itself, and not some other transaction, that must be the source of the tax reduction or avoidance. Where the provision applies, its sole consequence is to deem the share acquisition not to have occurred. The fact that this is the effect of the application of the rule underlines that it was presumed that by deeming the share acquisition (or disposition) not to have occurred, the tax saving that would otherwise have been realized will be denied to the taxpayer. However, as we explain later when we return to the examples in the draft ITTN, if that tax saving results from some other transaction in the series, subsection 95(6) will not operate to negate the tax benefit.

With respect to the proper interpretation of the purpose test, the decision of the Supreme Court in *Singleton v. Her Majesty The Queen*[69] is directly on point. The issue in that case was whether interest was payable on borrowed money used for the purpose of gaining or producing income and, as a result, was deductible under paragraph 20(1)(c). The taxpayer was a partner in a law firm who, on the same day, withdrew partnership capital, used the proceeds to buy a house, and borrowed money to replace his partnership capital. In determining whether the taxpayer met the required income-earning purpose test in respect of the use of the borrowed money to permit a tax deduction for the interest, the court was required to consider whether the purpose of the borrowing should be determined solely by reference to the actual use of the borrowed money or by reference to the entire series of transactions effected by the taxpayer.

The Tax Court had held that the purpose of the borrowing should be determined by reference to the entire series of transactions of which the borrowing and contribution to the partnership capital was a part and that it was, in effect, the "true economic purpose" of the series of transactions of which the borrowing was a part that was relevant. On the other hand, the Federal Court of Appeal held that each transaction in the series, including the borrowing, should be treated independently, not as a composite whole. The Federal Court of Appeal expressly rejected the reading of a "series of transactions" concept into paragraph 20(1)(c) in the absence of a clear intention of Parliament to do so.

In the Supreme Court, the majority upheld the decision of the Federal Court of Appeal: it was the purpose of a single transaction in the taxpayer's series—namely, the borrowing—rather than the purpose of the series of transactions that was relevant in applying paragraph 20(1)(c) because, in part, the language of the provision focuses on the transaction that is the borrowing.

To the extent that the CRA believes that its approach is supported by the jurisprudence, our view is that the CRA misconstrues the relevant cases. In *Canadian Pacific Limited v. The Queen*,[70] the Tax Court found that an overall primary commercial

69 2001 DTC 5533 (SCC); 99 DTC 5362 (FCA); 96 DTC 1850 (TCC).

70 2000 DTC 2428 (TCC).

purpose for a series of transactions permitted a finding that each transaction included within the series also had a primary commercial purpose. The court stated that

> [t]he transactions which the Respondent says constitute the series were, when viewed objectively, inextricably linked as elements of a process primarily intended to produce the borrowed capital which the Appellant required for business purposes. The capital was produced and it was so used. No transaction forming part of the series can be viewed as having been arranged for a purpose which differs from the overall purpose of the series.[71]

In the Federal Court of Appeal,[72] the lower court's decision was upheld and the passage above directly quoted; but we believe that at that level the court's decision was based on its conclusion that only one transaction had been put in issue—the borrowing—and that the currency of the borrowing could not be split off and viewed as a transaction separate from the borrowing. On the basis of the lower court's finding of fact that the borrowing had a primary commercial purpose, it was not an avoidance transaction. The Crown did not argue that the relevant principles had been wrongly applied by the Tax Court; rather, the Crown made a much narrower submission:

> Since it is not alleged that the Tax Court Judge applied the wrong legal test to determine CP's primary purpose, his finding that CP's primary purpose was not to minimize tax cannot be reversed by this Court unless the Appellant can establish that the Tax Court Judge made a palpable or overriding error that affected his assessment of evidence such that his finding of fact was clearly wrong.[73]

Other decisions of the Federal Court of Appeal make it clear that the purpose test that applies to determine whether a transaction is an avoidance transaction for the purposes of GAAR is applied on a transaction-by-transaction basis. For example, in *OSFC Holdings Limited v. The Queen*,[74] the Federal Court of Appeal stated:

> Once it is determined that a series of transactions results in a tax benefit, any transaction that is part of the series may be found to be an avoidance transaction. The question is the primary purpose of *each of the transactions in the series*. If the primary purpose of *any transaction* is to obtain the tax benefit, it is an avoidance transaction.[75]

The language used by the Supreme Court in its recent GAAR decisions also indicates acceptance of the principle that it is necessary to evaluate the purpose of each

71 Ibid., at paragraph 15.

72 *The Queen v. Canadian Pacific Limited*, 2002 DTC 6742 (FCA).

73 Ibid., at paragraph 28.

74 2001 DTC 5471 (FCA).

75 Ibid., at paragraph 45 (emphasis added).

transaction in a series (as opposed to the overall purpose of a series of transactions). In *Canada Trustco*, the Supreme Court said:

> According to s. 245(3), the GAAR does not apply to *a transaction* that "may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit." If there are both tax and non-tax purposes to a transaction, it must be determined whether it was reasonable to conclude that the non-tax purpose was primary. If so, the GAAR cannot be applied to deny the tax benefit.
>
> While the inquiry proceeds on the premise that both tax and non-tax purposes can be identified, these can be intertwined in the particular circumstances of *the transaction* at issue. It is not helpful to speak of the threshold imposed by s. 245(3) as high or low. The words of the section simply contemplate an objective assessment of the relative importance of the driving forces of the transaction.[76]

Thus, we do not see a basis upon which, on a textual approach, the CRA can sustain the argument that it is the purpose of a series of transactions of which a particular share acquisition is a part that is determinative of the purpose of that share acquisition, when the relevant test must be applied objectively.

Equally importantly, on a textual reading of the provision, there is no basis for the CRA's view that the provision is a discretionary one. The CRA acknowledges that construing the words to apply to every share acquisition that has a primary tax motivation would give rise to absurd results. To prevent the absurd and obviously unintended results that would flow from a broad reading of the words, the CRA proposes that the provision be read as if it had a built-in misuse or abuse test that limits the scope of the provision to those share acquisitions that have a primary tax motivation and that are offensive in some tax policy terms. Where this policy is to be found is, of course, another matter not addressed by the provision. Whereas the GAAR test is whether the provisions of a particular section of the Act have been misused or whether the provisions of the Act, read as a whole, have been abused,[77] nothing in paragraph 95(6)(b) provides any authority for limiting its application to abusive tax planning that results in tax benefits flowing from the status of a particular corporation as a foreign affiliate.

An alternative approach is to accept that the absence of words in paragraph 95(6)(b) that support the CRA's approach means that the words must have a meaning far more modest than the meaning ascribed to them by the CRA. In other words, the plain meaning or textual reading of the words must be other than the broad meaning ascribed to them by the CRA for the words to have the results that the CRA argues for, because there is no textual reading that can lead to those results.

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76 *Canada Trustco*, supra note 24, at paragraphs 27 and 28 (emphasis added).

77 In *Canada Trustco* and *Kaulius*, the Supreme Court synthesized the "misuse" and "abuse" concepts into a single "abusive tax avoidance" test. The court said that the determinations of "misuse" and "abuse" should not be considered separate inquiries; subsection 245(4) requires a single, unified approach to the textual, contextual, and purposive interpretation of the specific provisions of the Act that are relied on to determine whether there was abusive tax avoidance (*Canada Trustco*, supra note 24, at paragraph 43).

Support for the view that a court would be reluctant to give a broadly worded anti-avoidance provision that does not contain any explicit words restricting its ambit to abusive tax avoidance a narrow interpretation may be found in the decision of Bell J in *Canwest Capital Inc. v. The Queen*.[78] At issue was the application of the anti-avoidance rule in subsection 129(1.2), pursuant to which a dividend can be ignored if it is paid on a share that was acquired as part of a plan to generate a refund of refundable tax. In this respect, the provision is similar to paragraph 95(6)(b), under which a share acquisition can be ignored (that is, assumed not to have occurred).

Refundable tax is part of the integration system applicable to investment income of Canadian-controlled private corporations (CCPCs). The regime that governs investment income (including capital gains) of CCPCs is comparable to the foreign affiliate regime in that the overall objective of these rules is to ensure that the investment income of CCPCs can be passed through to the ultimate individual shareholders on a basis whereby the overall corporate-level and shareholder-level tax approximates the tax that would have been paid had the individual shareholders earned the income directly. The system relies on a part of the tax paid at the corporate level being notionally tracked in a refundable dividend tax on hand (RDTOH) account. When the corporation pays a taxable dividend, a dividend refund is generated on the basis of the RDTOH account.

In 1988, in response to certain schemes that were designed to allow a corporation to obtain a dividend refund without the related shareholder-level tax being paid (for example, a tax-exempt entity might hold transitory shares that would be redeemed in a way that would result in a large dividend, thereby triggering a dividend refund within the payer), the Department of Finance introduced a broadly worded anti-avoidance provision. The rule, contained in subsection 129(1.2), reads as follows:

> Where a dividend is paid on a share of the capital stock of a corporation and the share . . . was acquired by its holder in a transaction or as part of a series of transactions one of the main purposes of which was to enable the corporation to obtain a dividend refund, the dividend shall, for the purpose of subsection (1), be deemed not to be a taxable dividend.

In contrast to paragraph 95(6)(b), subsection 129(1.2) expressly directs that the purpose that must be considered is that of the transaction that is the share acquisition and that of the series of transactions of which the share acquisition was a part. The explanatory notes issued with the proposed legislation indicated that despite the broad words used, the rule was "not intended to interfere with the normal operation of subsection 129(1) as part of the system for integrating the taxes paid on investment income by a private corporation and the taxes paid by the shareholders on the subsequent distribution of that income."[79] In other words, the explanatory

78 97 DTC 1 (TCC).

79 Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax (Bill C-139)* (Ottawa: Department of Finance, June 30, 1988), subclause 117(1).

notes acknowledged that the broad wording could result in the denial of a dividend refund in the context of a transaction that was outside the intended scope of the rule, but confirmed that the rule was not intended to be applied in a way that would cause "normal" transactions to be affected.

In *Canwest*, the court refused to apply the rule. Several reasons were given for its non-application, including the fact that, on the evidence, the parties were either not aware of or not focused on the fact that the result of the transactions they undertook would be the creation of an opportunity for a dividend refund. However, the court's comments on the interpretation of this type of anti-avoidance provision are instructive and perhaps even prescient:

> A provision in a self-assessing taxation system should be clear and capable of ready comprehension. Subsection 129(1.2) falls short of this standard. Subsection 129(1) entitles a taxpayer to a dividend refund on the payment of taxable dividends. Subsection 129(1.2) disentitles a taxpayer to such refund without any description of circumstances justifying that result. The Court should be able to interpret legislation and to apply it to the facts without the task of having to divine meaning from an assemblage of words whose intended objective could hardly be better disguised. In such circumstance the Court must reluctantly resort to other materials in an effort to glimpse the creature concealed.[80]

The court found no evidence of any parliamentary debate on the provision and expressed concern with the lack of specificity in the provision itself about what was intended to be "normal" and not affected by the rule:

> It is normal for an informed taxpayer to establish a parent corporation and subsidiary corporation structure. It would be present to the founder's mind that the subsidiary would obtain a dividend refund upon the payment of a taxable dividend to its parent. Does the establishment of such a normal structure have as one of its purposes the ability of the subsidiary to obtain a dividend refund on payment of a taxable dividend? If the answer is negative no further analysis is required. If the answer is affirmative, what elevates that purpose to being a main purpose under subsection 129(1.2)? The Technical Notes inform us that the government's concern is no "related shareholder tax being paid." That concern is not expressed in the provision under examination. How can subsection 129(1.2), without more, characterize the ability of a subsidiary corporation to receive a dividend refund, the normal result of paying a taxable dividend, as one of the main purposes for the acquisition of its shares by that related shareholder? Surely it is the combination of the normal ability to receive a dividend refund together with *something else* that is the target of subsection 129(1.2). Why does it not describe what that something else is? This is an anti-avoidance section that does not indicate what structures and/or transactions it seeks to redress.[81]

80 Supra note 78, at 4.

81 Ibid., at 4-5.

The *Canwest* decision is instructive with respect to the proper caution that should be and, we believe, will be exercised by the Canadian courts in interpreting paragraph 95(6)(b). It supports our view that the courts will be reluctant to give the paragraph the meaning that the CRA has asserted it should be given. Like the provision considered in *Canwest*, paragraph 95(6)(b) does not indicate what structures and/or transactions it seeks to redress, and without being given a narrow interpretation would apply (contrary to the explanatory notes issued with the introduction and subsequent amendment of paragraph 95(6)(b)) to all manner of normal structures to which it could never have been intended to apply.

In several important decisions, the Supreme Court has also confirmed its aversion to interpreting tax legislation in a manner that leads to "administrative legislation," under which taxpayers are inevitably treated differently by virtue of the CRA's exercise of administrative fiat, no matter how well intentioned. In *Singleton*,[82] the Supreme Court confirmed that when a taxpayer had structured his affairs to enable him to directly trace the use of borrowed funds to an eligible income-earning purpose, the minister could not succeed on the basis of an argument that the legal steps that supported the direct tracing of the funds should be ignored. In an interesting passage, the majority of the court reaffirmed the principle enunciated in *The Queen v. Bronfman Trust*[83] that "[f]airness requires that the same legal principles must apply to all taxpayers, irrespective of their status as natural or artificial persons, unless the Act specifically provides otherwise."[84]

In *Ludco Enterprises Ltd. et al. v. Her Majesty The Queen*,[85] a companion case on interest released concurrently with *Singleton*,[86] the Supreme Court made the same point. *Ludco* also dealt with the proper interpretation to be given to the purpose test in subparagraph 20(1)(c)(i), although the issue before the court was different from the issue in *Singleton*. In *Ludco*, the taxpayer had invested in shares of a non-Canadian corporation on which approximately $600,000 of dividends were received over the course of a period during which approximately $6 million of interest expense was incurred on the borrowing to acquire the shares. The court found that the requirements of subparagraph 20(1)(c)(i) had been met. Evidence was led that the CRA's administrative position had consistently been to allow the deduction of interest on money borrowed to purchase common shares even if no dividends were ever paid, and yet the CRA had reassessed the taxpayers when they had borrowed to acquire shares of a foreign corporation on which an actual dividend had been received.

Primarily, the Crown argued that the purpose test in subparagraph 20(1)(c)(i) should be read as requiring a bona fide and dominant purpose. In rejecting this argument, the court stated:

82 Supra note 69.

83 87 DTC 5059 (SCC).

84 Ibid., at 5064.

85 2001 DTC 5505 (SCC).

86 Supra note 69.

> Reading such tests into s. 20(1)(c)(i) would require a rewriting of the provision to introduce a concept of degree, exclusivity, or primacy in the taxpayer's purposes. Presumably, a court would take such an approach in response to concerns over tax avoidance. However, this Court has repeatedly stated that in matters of tax law, a court should always be reluctant to engage in judicial innovation and rule making: see *Sparrow Electric Corp.*, supra; *Canderel*, supra; and *Shell Canada Ltd.*, supra. Furthermore, the application of any such test is impractical in the context of investments in securities. It would open the door to many reassessments and in each case impose on taxpayers a tremendous burden to justify that their real or dominant purpose was to earn income.[87]

The reason for the court's aversion to being put in the position of rule maker rather than interpreter of rules is evident from the draft ITTN. In the first few examples in the draft ITTN discussed above, the CRA demonstrates the problems that flow from treating the same or similar arrangements of two taxpayers differently on the basis of the CRA's determination that some overarching tax policy that is not found in the relevant provisions of the Act has been contravened or circumvented.

The Contextual Approach

We believe that a proper contextual consideration of paragraph 95(6)(b) requires that the provision be assessed both in the immediate context of the foreign affiliate rules in the Act, of which it is clearly intended to be an important part, and in the overall context of the Act, with reference to other anti-avoidance provisions (principally, GAAR) that are clearly intended to have broad application.

The immediate context is a set of complex and specific rules that must be taken to represent the current view of the Department of Finance (and, by extension, of Parliament) as to what constitutes an appropriate system for taxing Canadians on the earnings of their foreign affiliates.[88] As we have seen, these rules include bright-line tests for determining when a particular corporation is a foreign affiliate or a controlled foreign affiliate of a Canadian taxpayer. The starting premise must be that these thresholds were deliberately chosen and that a taxpayer who has an investment in a foreign corporation that meets the required threshold to be characterized

87 *Ludco*, supra note 85, at paragraph 53.

88 Although we do not discuss the proposed NRT and FIE regimes in this article, they represent yet another set of specific rules that are intended to counter avoidance or deferral of tax by Canadians who invest in offshore entities. In general terms, the NRT rules are intended to counter avoidance that results from the direct or indirect transfer of property by Canadian residents to non-resident trusts; the FIE rules are aimed at investments by Canadian residents in offshore entities that primarily derive investment income. Thus, the rules respect the basic premise of the foreign affiliate system that "active" income of a foreign corporation in which a Canadian invests should not be taxed in Canada on a current basis. Although there is some overlap between the FIE rules and the foreign affiliate rules, the working premise is that where passive income is earned in a controlled foreign affiliate of a Canadian taxpayer, that income should be taxed as FAPI under the relevant foreign affiliate rules and should not also be taxed under the FIE rules.

as a foreign affiliate of the taxpayer was intended to obtain the tax benefits associated with that status (and, as a corollary, a taxpayer who has an investment in a controlled foreign affiliate was intended to suffer the adverse consequences, if any, associated with that status). In this context, it is understandable that manipulation of share ownership to create a transitory relationship, or one with no economic consequences (other than the tax benefits associated with the relationship), for the specific purpose of obtaining a tax benefit to which there would be no entitlement absent the share acquisition (or disposition), should probably disentitle a taxpayer to the tax benefit. However, as even the CRA acknowledges, it cannot be the case that every share acquisition that results in a foreign corporation having foreign affiliate status in relation to a Canadian taxpayer, even if motivated by a desire to obtain the tax benefits associated with that status, is susceptible of being ignored under paragraph 95(6)(b). In other words, the provision is far too blunt an instrument if it is given the CRA's interpretation.

With respect to the proper focus of the purpose test, a key aspect of the context of paragraph 95(6)(b) is the consequence that results where the provision applies. The starting point is the premise that the legislative drafters of the provision must have intended that where the conditions for its application were present, including the requisite tax avoidance or reduction, the consequence mandated in the provision would eliminate the tax avoidance or reduction. The sole consequence of paragraph 95(6)(b)'s application is that the share acquisition described in the provision is deemed not to have occurred and, if previously unissued shares were acquired, the shares are deemed not to have been issued. The legislative drafters were satisfied that deeming the share acquisition not to occur would eliminate the tax avoidance or reduction at which paragraph 95(6)(b) was aimed; this is compelling evidence that the source of the tax avoidance or reduction, and the proper focus of the purpose test, must be the share acquisition, not the series of transactions that includes the acquisition or some other transaction.

It seems odd that if the legislative drafters intended that the purpose of something other than the share acquisition itself could be determined to be the source of the tax avoidance, reduction, or deferral, the consequence of the provision's application would be limited to deeming the share acquisition not to have occurred. There could be no assurance that some other transaction in the series of transactions or the series itself might not be the source of the actual tax avoidance, reduction, or deferral. If the legislative intent was that the purpose of the series of transactions and not simply the share acquisition was relevant, the consequence of the provision's application would have been much different in order to ensure that the source of the tax avoidance, reduction, or deferral was eliminated.

A sensible reading is that the legislative drafters intended that the source of the tax avoidance, reduction, or deferral was one transaction and one transaction only—the acquisition of shares—and that that transaction alone should be the focus of the purpose test. Where the tax avoidance, reduction, or deferral purpose test is met and the provision read this way applies, the tax avoidance, reduction, or deferral is eliminated because the consequence of the provision's application is that the source

of the tax avoidance, reduction, or deferral—namely, the share acquisition—is deemed not to have occurred.

In the examples given in the draft ITTN, there is no assurance that the abusive tax avoidance that the CRA identifies can be eliminated by deeming a particular share issuance not to have occurred. As the CRA acknowledges in the draft ITTN, the first two examples (the classic double dip and debt importation) result in the same end structure. Yet the CRA concludes that the classic double dip example is acceptable tax planning and the debt importation example is abusive. The only difference between the two structures is that in the classic double dip, the interest expense relating to financing of FA Opco was always in Canada. In the debt importation example, the order of the transactions was simply reversed.

Surely, what is offensive, if anything, is the fact that an interest deduction is obtained in two jurisdictions. While denying foreign affiliate status to Finco in the debt importation structure but not in the classic double dip structure may, to the extent that Finco distributes the interest it receives as dividends, have the same net effect, measured in terms of tax payable, as if the CRA had challenged the interest deduction on the new borrowing "imported" into Canada in the debt importation structure, the CRA chooses instead to assert that the share acquisition in this structure is a "bad" acquisition and should be ignored.

Consider what the CRA's argument would be if Finco had already been incorporated by Canco and was carrying on an active business in the foreign jurisdiction (in other words, pre-existing share issuances made Finco a foreign affiliate of Canco). To import the debt, Canco would simply contribute the interest-bearing debt in the CRA's example to Finco for additional shares of Finco. The acquisition of those shares would not have caused Finco to have foreign affiliate status in relation to Canco. If paragraph 95(6)(b) is invoked to ignore the new share acquisition for the purposes of the foreign affiliate rules only, Canco's interest expense on the imported debt remains deductible under paragraph 20(1)(c). Even if the particular share acquisition is ignored, the deduction under subsection 113(1) for dividends received by Canco from Finco should still be available, because (unless paragraph 95(6)(b) can be asserted to have applied to an earlier share acquisition) the dividends will still be received on shares of a foreign affiliate of Canco.

In each of the examples, it is difficult to see how the tax avoidance or reduction can be considered to emanate from the holding of the shares of the foreign affiliate and the earning of dividend income on those shares. Rather, if tax is avoided or reduced, the tax benefit derives from the interest expense. The fact that dividends on the Finco shares are deemed to be sourced in active earnings because of the use of the funds to earn active business income in the foreign (treaty) jurisdiction is simply a function of the application of the relevant foreign affiliate rules. Where the holder of those shares can be objectively expected to earn a net positive, reasonable rate of return on the share investment, and the acquisition of the shares is not a transitory arrangement designed to satisfy in some artificial manner the requirements of the foreign affiliate definition, we believe that the purpose of the share acquisition is

self-evident and should not, in most cases, be characterized as something other than to earn the investment return.

We turn now to the bigger picture and whether, in the context of the Act as a whole, paragraph 95(6)(b) stands up as the general anti-avoidance provision the CRA argues that it is. We believe that a comparative review makes it clear that paragraph 95(6)(b) is a limited anti-avoidance provision with appropriately modest scope if interpreted properly. In other words, its plain meaning should only become plainer when read in the specific context of the foreign affiliate rules of which it is a part and when it is compared to other, more general, anti-avoidance rules that expressly adopt some of the tests that the CRA thinks should be read into paragraph 95(6)(b).

The Act contains many specific anti-avoidance provisions as well as section 245 (GAAR). Most of the anti-avoidance rules embody some form of purpose or results test as a required condition for their application. It is noteworthy that many use the phrase "series of transactions," sometimes alone, but often in conjunction with the word "transaction." In other words, the distinction between a transaction and a series of transactions is well established in the Act. In paragraph 95(6)(b), the legislative drafter could have used the concept of a series of transactions of which the share acquisition was a part. Equally important, several anti-avoidance provisions, such as subsection 129(1.2), expressly refer to the concept of the purpose of a series of transactions, in some cases in conjunction with a reference to the purpose of a transaction, presumably reflecting the reality that the purpose of a particular transaction and the purpose of the series of transactions of which the particular transaction is a part might be different. One example is subparagraph (i.1)(ii) of the "term preferred share" definition in subsection 248(1), which provides that a share may be deemed to be a preferred share where, inter alia, "it may reasonably be considered that the share was issued or acquired as part of a transaction or event or series of transactions or events one of the main purposes of which was to avoid or limit the application of subsection 112(2.1) or 138(6)." Another example is subsection 55(2), which applies where a taxable dividend is received "as part of a transaction or event or a series of transactions or events, one of the purposes of which. . . ."

Given the varied language used in these and other anti-avoidance provisions of the Act, we do not believe that on either a textual or a contextual reading of paragraph 95(6)(b) a court could reasonably read in a broader focus for the purpose test than that which the provision expressly provides. In particular, to apply the purpose test in paragraph 95(6)(b) not solely to the share acquisition but to a series of transactions that includes the share acquisition is to read in a test that has been expressly adopted in other provisions but is simply not present in the language of paragraph 95(6)(b). One can only assume that the omission is intentional. If the legislators intend that the purpose of a whole series of transactions is to be taken into account in determining the tax consequences of a particular transaction that is part of that series, the drafting convention that should be used to accomplish this end is clear from other provisions of the Act.

We also believe that when paragraph 95(6)(b) is considered in the context of other provisions of the Act, it is clear that it cannot be interpreted as a form of general

anti-avoidance rule that may or may not apply (or be applied) depending on whether some overarching policy (such as a policy that allows Canadian multinational groups to use the foreign affiliate rules to their advantage but does not allow Canadian corporations that are part of a foreign-controlled multinational group the same access to the rules) is offended.

Paragraph 95(6)(b) does not have any of the important safeguards and trappings of a general anti-avoidance rule. In particular, unlike subsection 245(4), it does not have a rule that places an important limitation on its scope to ensure that it does not apply simply because a transaction has a primary tax-avoidance or tax-reduction purpose. Subsection 245(4) provides that subsection 245(2) does 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 the Act, or an abuse having regard to the provisions of the Act read as a whole. As subsection 245(4) anticipates, many avoidance transactions might have the requisite tax-avoidance purpose and still not constitute unacceptable tax planning.

Further, while the decision to apply GAAR to a particular transaction or series of transactions is, in one sense, a discretionary one (because the decision to assess is within the control of the minister and not the taxpayer), it is clear that the determination of whether the particular planning constitutes abusive planning is made by the court. The rule's application does not depend on whether, in the minister's view, the planning offends some tax policy that the minister believes should be reflected in the Act or that the minister determines can be divined from extrinsic aids describing general government policy. Instead, the rule's application must be determined on the basis of a consideration of the object, spirit, or purpose of the particular provisions of the Act on which the taxpayer relies for the tax benefit. This is the essence of the Supreme Court's decision in *Canada Trustco*.[89] In that case, the court expressly rejected the proposition that GAAR should apply, or not, on the basis of a search for some overarching policy that was not based on the scheme of the Act, the relevant provisions, and permissible extrinsic aids.[90] The court articulated the approach in the following terms:

> [Subsection] 245(4) does not consider a transaction to result in abusive tax avoidance merely because an economic or commercial purpose is not evident. As previously stated, the GAAR was not intended to outlaw all tax benefits; Parliament intended for many to endure. The central inquiry is focussed on whether the transaction was consistent with the purpose of the provisions of the *Income Tax Act* that are relied upon by the taxpayer, when those provisions are properly interpreted in light of their context. Abusive tax avoidance will be established if the transactions frustrate or defeat those purposes.[91]

89 Supra note 24.

90 Ibid., at paragraph 55.

91 Ibid., at paragraph 57.

As to the level of certainty that must exist to determine that allowing the tax benefit would frustrate or defeat the purpose of the relevant provisions, the court stated:

> The GAAR may be applied to deny a tax benefit only after it is determined that it was not reasonable to consider the tax benefit to be within the object, spirit or purpose of the provisions relied on. . . . [T]he starting point for the analysis is the assumption that a tax benefit that would be conferred by the plain words of the Act is not abusive. This means that a finding of abuse is only warranted where the opposite conclusion—that the avoidance transaction was consistent with the object, spirit or purpose of the provisions of the Act that are relied on by the taxpayer—cannot be reasonably entertained.[92]

In the sixth guideline set out in the judgment, these principles were summarized as follows:

> 6. Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.[93]

The absence of any provision in paragraph 95(6)(b) that ensures that its scope is limited to those transactions that result, or are part of series of transactions that result, in an abuse of specific provisions of the Act or the provisions of the Act read as a whole is, we believe, compelling contextual evidence that, unlike GAAR, paragraph 95(6)(b) is not intended to be a general anti-avoidance rule. In our view, the paragraph is appropriately understood as a narrower rule that is applicable only where it is clear that a particular share acquisition (or disposition) that results in a corporation having foreign affiliate status (or in a corporation not having controlled foreign affiliate status) would frustrate or defeat the purposes of the foreign affiliate rules in the Act.

Finally, we suggest that there is an additional important reason why paragraph 95(6)(b), read in the context of GAAR, fails as a general anti-avoidance rule. Where paragraph 95(6)(b) applies, its consequences are simple—to deem the share acquisition (or issue) not to have occurred. In sharp contrast, where GAAR applies, the tax consequences of the avoidance transactions are to be determined, pursuant to subsection 245(2), as is reasonable in the circumstances in order to deny the tax benefit that would result in the absence of the application of GAAR.

As discussed above, the CRA's view is that denying foreign affiliate status to a foreign corporation by applying paragraph 95(6)(b) to allow a share acquisition to be ignored will properly address the perceived tax avoidance. But this tactic works only for some taxpayers and only some of the time. In the financing structures with which the CRA seems most concerned, the real avoidance, if it exists, lies in the fact

92 Ibid., at paragraph 62.

93 Ibid., at paragraph 66.

that the Canadian corporation either has borrowed to acquire the shares and thus generated an interest expense in Canada, or has used surplus funds to make the investment, resulting in an erosion of the Canadian tax base through shifting of the earnings on such surplus funds to an offshore affiliate. If the proper initial structure (a pre-existing foreign affiliate) is in place, the CRA should have no basis for asserting that paragraph 95(6)(b) applies to a subsequent share investment.

The Purposive Approach

We believe that by "purposive approach" the Supreme Court meant the exercise of attempting to determine what Parliament intended when it enacted the particular provision that either the taxpayer or the minister seeks to rely upon—and not, for example, the CRA's view of what should or should not be permitted, or some academic notion of what good tax policy might be. In *Canada Trustco*, the Supreme Court said that

> [t]here is but one principle of interpretation: to determine the intent of the legislator having regard to the text, its context, and *other indicators of legislative purpose*.[94]

And further:

> Even 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. "After all, language can never be interpreted independently of its context, and *legislative purpose* is part of the context. It would seem to follow that *consideration of legislative purpose* may not only resolve patent ambiguity, but may, on occasion, reveal ambiguity in apparently plain language." See P.W. Hogg and J.E. Magee, *Principles of Canadian Income Tax Law* (4th ed. 2002), at p. 563.[95]

Although the Supreme Court seemed to wish to disassociate itself from the formulation of the principles developed by the Federal Court of Appeal in its approach to the application of GAAR (as principally embodied in the *OSFC Holdings* case), this articulation of the appropriate approach does not seem to us to be a fundamental departure from the Federal Court of Appeal's statements about whose policy must be identified. The Federal Court of Appeal made it clear that part of the analysis necessary in determining whether GAAR should be applied is the identification (if possible) of the policy underlying the particular provision that is alleged to have been misused or abused. However, that policy was clearly legislative, not some policy that the court, much less the CRA, might think appropriate:

> In enacting subsection 245(4), Parliament has placed the duty on the Court to ascertain *Parliament's policy*, as the basis for denying a tax benefit from a transaction that otherwise would meet the requirements of the statute. Where Parliament has not been

94 Ibid., at paragraph 40 (emphasis added).

95 Ibid., at paragraph 47 (emphasis added).

> clear and unambiguous as to its intended policy, the Court cannot make a finding of misuse or abuse, and compliance with the statute must govern.[96]

Where does one turn, then, to ascertain parliamentary policy? In *Canada Trustco*, the Supreme Court said, "The first step is to determine the object, spirit or purpose of the provisions of the *Income Tax Act* that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids."[97]

For the scheme of the Act, one presumably has regard to an overall regime or system for taxing similar types of taxpayers or similar types of transactions—such as the basic regime for taxing Canadian corporations, or for taxing Canadian corporations on earnings from foreign affiliates. In discerning the scheme of the Act, one must look to the history and evolution of the provisions.

It is well established that permissible extrinsic aids used in such an investigation include parliamentary debates and the Department of Finance's explanatory notes published with respect to a particular provision. If we turn to such extrinsic aids, we do not find any evidence that paragraph 95(6)(b) was intended by Parliament to be a general anti-avoidance provision. With respect to the CRA's view that the purpose of a series of transactions of which a share acquisition is a part is the relevant inquiry, we believe that the Department of Finance's explanatory notes support the position that the proper focus of the purpose test in paragraph 95(6)(b) is the subject share acquisition and that the concern is with transactions that artificially manipulate share ownership in order to allow a taxpayer to obtain a reduction or avoidance of tax that, but for the acquisition, would otherwise have been payable.

As we discussed earlier in our review of the legislative history of paragraph 95(6)(b), one of the key changes to paragraph 95(6)(b) was the rewriting of the paragraph so that it would apply even if the subject share acquisition itself resulted in foreign affiliate status. Prior to the amendments, the opening words of paragraph 95(6)(b) referred to a "foreign affiliate" of a taxpayer or "any non-resident corporation controlled . . . by the taxpayer or by a related group" having issued shares for the purpose of reducing or postponing tax. As the explanatory notes state,

> Paragraph 95(6)(b) has been rewritten and applies to an acquisition or disposition of shares where the principal purpose for such acquisition or disposition was the avoidance, reduction or deferral of amounts payable under the Act. If the principal purpose exists, the shares are deemed not to have been acquired or disposed of and previously unissued shares are deemed not to have been issued.[98]

There is not even a suggestion that the overall purpose of a series of transactions of which a share acquisition is a part is the relevant inquiry.

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96 *OSFC Holdings*, supra note 74, at paragraph 70 (emphasis added).

97 *Canada Trustco*, supra note 24, at paragraph 55.

98 Supra note 12.

The single example given in the explanatory notes involves a Canco with a wholly owned foreign subsidiary (FC). An unrelated Canadian corporation (X Co) is to lend money to FC. X Co forms a wholly owned foreign subsidiary (FX) to make the loan to FC. Since the interest income earned by FX would result in X Co reporting FAPI in respect of FX's earnings, X Co acquires an 11 percent share interest in FC in order to recharacterize FAPI to income from an active business. The shares of FC held by X Co are to be sold back to Canco when the loan is repaid. Canco has a right of first refusal at an agreed price in the event that X Co sells the FC shares. The notes describe subsection 95(6) as applying to an acquisition of shares of a foreign corporation by a Canadian corporation in circumstances where, absent the acquisition, the Canadian corporation would otherwise be subject to Canadian income tax on FAPI. As a consequence solely of the share acquisition, the Canadian corporation avoids or reduces its tax otherwise payable on the foreign income.

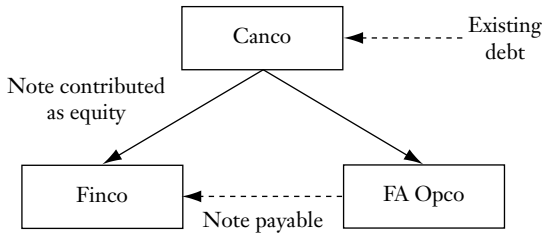
In the draft ITTN, the CRA repeatedly refers to a policy that tax planning involving the use of the foreign affiliate rules to benefit a Canadian taxpayer is not abusive if the structure "enhances the competitiveness abroad" of a Canadian corporation, but that planning based on precisely the same rules is generally abusive if no such enhancement results. This policy is used to justify the CRA's position that a financing structure in which a Canadian subsidiary of a foreign parent company invests funds in a sister company (either directly, by way of preferred share investment, or indirectly, by way of investment in a financing subsidiary that lends money to the related foreign corporation) is offensive in policy terms. It is also used to justify the CRA's view that paragraph 95(6)(b) would not be applied in the classic double dip structure outlined in the draft ITTN.

In concluding that paragraph 95(6)(b) did not apply to the classic double dip, the CRA said that the structure enhanced the competitiveness of a Canadian company, and consequently was not offensive in policy terms, because "Canco participates fully in the growth in the value of FA Opco through its investment in the common shares of FA Opco." However, if this is the policy, it is unclear why the structure in the debt importation example, which is identical in its result, does not foster Canadian competitiveness in the same way. In connection with that example, the CRA states that the steps offend a policy against erosion of the Canadian tax base through the shifting of deductible expenses to Canada.

The first two examples in the draft ITTN demonstrate the folly of the CRA's interpretive approach to paragraph 95(6)(b). The CRA looks at two series of transactions that clearly are largely motivated by tax considerations and that have the same end result, and it concludes that paragraph 95(6)(b) applies to one but not to the other. This distinction is not based on the different legal character of the subject transactions; instead, it is based on tax policy considerations that the CRA identifies not from the relevant provisions of the Act, but from its reading of extrinsic aids.

Suppose that the starting point for the debt importation example in the draft ITTN is altered slightly so that the existing interest-bearing debt in FA Opco is owed to Canco and that Canco has borrowed to on-lend to FA Opco. Suppose too that Canco simply incorporates Finco and contributes the debt to Finco for shares. (See figure 4.)

FIGURE 4



The tax motivation for such an arrangement is clear; however, no debt has been imported into Canada, so presumably the CRA would say that paragraph 95(6)(b) has no application to this arrangement. The CRA might conclude that the equivalent of debt importation has been effected through a shifting of the income earned on the existing debt outside Canada; on the basis of some of the other examples, however, it is difficult to see how the CRA could sustain the argument that the shifting of income to a foreign affiliate is, in and of itself, contrary to an identified tax policy.

The point of the foregoing discussion is not to debate whether the CRA's tax policy determinations are being applied on a consistent basis in these examples; they clearly are not. The real question is this: Why does the CRA believe that this is the proper interpretation of paragraph 95(6)(b)? The CRA's view is that paragraph 95(6)(b) requires the CRA and, ultimately, the Canadian courts to determine as a matter of tax policy whether the provision applies in a particular case. On the basis of these tax policy determinations, the CRA believes that paragraph 95(6)(b) may or may not apply to identical arrangements that are effected by taxpayers in different ways. Reduced to its essence, the CRA's interpretation seems to be that when a series of transactions involves the acquisition or disposition of shares of a foreign affiliate and the series achieves Canadian tax benefits, paragraph 95(6)(b) applies to deny such an acquisition or disposition if achieving such tax benefits is contrary to tax policy. The determination of what constitutes tax policy is to be made by reference to extrinsic aids—to date, primarily by the CRA reviewing statements made from time to time by officials of the Department of Finance.

We submit that no evidence of the policies on which the CRA bases its distinctions can be found in the scheme of the foreign affiliate rules in the Act. In fact, given the regular and extensive amendments that have been made to the foreign affiliate provisions over the years, including paragraph 95(2)(a), one can only conclude that such provisions are a more accurate and reliable reflection of tax policy. It is true that when the foreign affiliate system as we now know it was introduced, one of the objectives was to ensure that the passive income rules that had been proposed as part of the 1971 tax reform did not apply too broadly to the detriment of Canadian multinational corporations. In the supplementary information to the May 6, 1974 Budget, the Department of Finance stated:

> The proposal to exclude from tax the income generated from transactions between related foreign entities would take the income generated in the overseas business operations of multinational Canadian corporations out of the passive income rules. Thus, tax would not apply in future to such things as interest received by an international financing subsidiary on loans extended to related foreign companies within the group, or to rents, royalties and technical fees received from related foreign affiliates by an affiliate formed abroad to hold property and exploit know-how.[99]

However, nothing in the budget papers or, more importantly, in any of the accompanying legislation distinguished in any way between the treatment of a Canadian corporation in regard to income earned by its foreign affiliates where that corporation was Canadian-controlled or a Canadian public corporation, and the treatment of a Canadian corporation with foreign affiliates where that corporation was foreign-controlled. While a desire to create a competitive advantage for Canadian multinationals with foreign operations may have been one reason for the overall design of the system, it cannot have been the sole purpose of the rules. It must have been obvious to the legislators (and thus it must be presumed to be an intentional result) that in the absence of any limitation on the type of Canadian corporation that could benefit from the rules, the same rules that would benefit Canadian multinationals would benefit other corporations that chose to subject themselves to the Canadian tax regime as Canadian-resident corporations, whether or not they were foreign-owned. When Parliament has chosen to apply different rules to the tax treatment of a foreign affiliate, depending on whether its ultimate parentage is Canadian or foreign (as in the case of subsection 17(2), the indirect loan rule discussed in detail earlier in this article), it has done so.

If a misuse or abuse test were overlaid on paragraph 95(6)(b), and if the test were to be applied as suggested by the Supreme Court in the guideline set out above, we believe it to be absolutely clear that the examples in the draft ITTN and other commentary would not hold up. For example, as we have seen, the CRA has expressed the view that it is probably acceptable for a Canadian corporation that is a subsidiary of a foreign parent corporation to acquire common shares of a related corporation that, as a consequence of such an acquisition, becomes a foreign affiliate of the Canadian corporation, but that it is not acceptable for that same Canadian corporation to acquire preferred shares of a related corporation that thereby becomes a foreign affiliate. Given that the definition of "foreign affiliate" makes no distinction between participating shares and fixed-value shares and, moreover, prescribes an extremely low threshold (with no hint at a votes and/or value test) for a foreign corporation to be a foreign affiliate of a Canadian corporation, we do not see how a common share investment could be considered to have a proper basis relative to the object, spirit, or purpose of the foreign affiliate definition, but a preferred share investment could

99 Canada, Department of Finance, 1974 Budget, Supplementary Information, May 6, 1974, at 30.

be found to be "wholly dissimilar" to the types of relationships or transactions contemplated by the provisions.[100]

In *Canada Trustco*, the Supreme Court took issue with the approach to the misuse or abuse test in subsection 245(4) that had been adopted by the Federal Court of Appeal in *OSFC Holdings*.[101] In particular, the court stated:

> To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. Did Parliament intend judges to formulate taxation policies that are not grounded in the provisions of the Act and to apply them to override the specific provisions of the Act? Notwithstanding the interpretative challenges that the GAAR presents, we cannot find a basis for concluding that such a marked departure from judicial and interpretative norms was Parliament's intent.[102]

One can debate whether the Supreme Court correctly described the interpretive approach adopted by the Federal Court of Appeal in *OSFC Holdings* on this point.[103] However, there should be no doubt that the interpretive approach that the CRA is asserting in relation to paragraph 95(6)(b) runs directly counter to the clear direction of the Supreme Court as expressed in the extract quoted above. In its approach to paragraph 95(6)(b), the CRA has assumed that Parliament intended that the CRA and, ultimately, the courts would determine, seemingly on the basis of their view of proper tax policy divined from extrinsic aids, whether a particular acquisition of shares of a foreign affiliate should be respected or ignored for tax purposes. In the context of applying subsection 245(4) (which is part of GAAR, a provision clearly intended by Parliament to alter, in cases where it is applicable, tax results that would otherwise prevail under the relevant provisions of the Act), the Supreme Court has expressly rejected such a role for the courts. It is difficult in the extreme to understand the CRA's thinking that such a role is mandated for it, and ultimately for the courts, in the language and context of paragraph 95(6)(b).

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100 See guideline 6 in *Canada Trustco*, supra note 24, at paragraph 66, where the court said that "[a]busive tax avoidance" could be found where the relationships or transactions were "wholly dissimilar" to the relationships or transactions contemplated by the provisions.

101 Supra note 74.

102 *Canada Trustco*, supra note 24, at paragraph 41.

103 Although the Supreme Court seemed to think that its approach in this regard was different from what had been said by the Federal Court of Appeal in *OSFC Holdings*, we are not sure that there was any real difference, even if the Supreme Court preferred its articulation of the tests. As noted earlier, the Federal Court of Appeal made it clear in *OSFC Holdings* that the policy that must be contravened in order for the taxpayer to be denied tax benefits that are otherwise within the letter of the law must be based on the relevant provisions of the Act, or the Act when read as a whole. In other words, the policy (or the object and spirit, or the scheme) must be based on the provisions of the Act and not on something else.

At present, the sole jurisprudence on paragraph 95(6)(b) is the *Univar* case. For the reasons cited earlier, the case is not particularly illuminating because of the manner in which the Crown's case was presented, which allowed the court to make a narrow ruling based on a finding of fact.

However, some aspects of *Univar* are helpful in supporting our analysis of the potential application of paragraph 95(6)(b). The court's determination that the actual transactions effected by the taxpayer did not avoid or reduce tax otherwise payable was sufficient for it to conclude that paragraph 95(6)(b) did not apply. However, the court also considered whether the purpose test in the provision had been met, and its approach seems consistent with our analysis—that is, that the relevant purpose is that of the share acquisition and nothing else, including the series of transactions of which the share acquisition is a part. On this point the court states:

> Paragraph 95(6)(b) requires the principal purpose of the share acquisition to be the avoidance, reduction or deferral of tax otherwise payable. As I have already decided that there was no tax otherwise payable to avoid, reduce or defer, subsection [95(6)] cannot apply.
>
> If it were necessary for me to decide, under subsection 95(6), whether it could reasonably be considered that the principal purpose for the acquisition of shares of Barbadosco by the Appellant was to permit the Appellant
>
> > . . . to avoid, reduce or defer the payment of tax . . . that would otherwise be payable.
>
> I would have found on a factual basis that it could not be so considered.[104]

Although it is clear that the court's basic conclusion that there was no avoidance or deferral of tax otherwise payable colours the rest of its decision, including its determination that the principal purpose of the acquisition of the foreign affiliate's share was not tax avoidance, the court's focus on the principal purpose of the share acquisition and not something else is important and is consistent with our analysis.

There are aspects of the decision that are perhaps less supportive of our analysis. First, notwithstanding our view that subsection 95(6) is a specific anti-avoidance rule that is aimed at a particular mischief and should not be applied on the same footing as the general anti-avoidance rule in section 245, the court in *Univar* seems to treat subsection 95(6) as equivalent to section 245. In particular, the court seems to treat the "tax otherwise payable requirement" in paragraph 95(6)(b) as the equivalent of the "tax benefit" requirement in section 245. We believe that the two requirements are quite different in their nature and operation: paragraph 95(6)(b) requires a much more direct linkage between the acquisition of the foreign affiliate shares and the avoidance or reduction of tax than section 245 requires between that transaction and the tax benefit. In our view, in the case of paragraph 95(6)(b), the reduction or

104 *Univar*, supra note 26, at paragraphs 45-46.

avoidance in tax otherwise payable must be the primary purpose of the share acquisition and must result from the share acquisition; in the case of section 245, for the share acquisition to be an avoidance transaction its primary purpose must be to obtain a tax benefit (that is, an avoidance or reduction of tax), but the tax benefit may result from the share acquisition or from the series of transactions of which it is a part. Stated simply, for paragraph 95(6)(b) to apply to the acquisition of the shares of a foreign affiliate, the avoidance or deferral of tax (that is, the tax benefit) must result from the share acquisition itself and not (in contrast to section 245) from the series of transactions of which the share acquisition is a part.

At certain points in *Univar*, the court does not seem to make this important distinction. In particular, the court juxtaposes the paragraph 95(6)(b) and section 245 requirements on a template that seems to treat the "tax otherwise payable" requirement in paragraph 95(6)(b) and the "tax benefit" requirement in section 245 as if they were equivalent to one another. However, when the court focuses on the primary purpose test in paragraph 95(6)(b), it correctly describes the primary purpose test—that is, it links the primary purpose to the share acquisition, not to the series of transactions of which it is a part.

We note that the facts in the *Univar* case were unusual, in that the Canadian taxpayer was able to establish that there were significant non-Canadian tax reasons for the subject transactions. As Univar Canada had significant retained earnings represented by surplus cash, and more were expected—its Canadian business was very profitable. Univar Canada had made some strategic Canadian acquisitions, but there were no attractive ones left; it was actively looking for ways to invest its surplus cash to generate acceptable returns. Further, Univar Canada had acted as a guarantor under certain credit agreements entered into by its US parent, and the US parent had been advised that for US tax purposes it might be deemed to have received as a dividend most, if not all, of Univar Canada's earnings. The guarantee arrangements created US tax issues for the US parent by generating excess foreign tax credits that the US parent might not be able to use. In addition, there were significant structural issues in the organization of the European subsidiaries that were resolved as part of the subject transactions. Finally, the US parent held the $27 million loan receivable from a European subsidiary, and there were concerns that the US parent was holding a disproportionate amount of the debt of its subsidiaries.

Against that background, the court concluded that Canadian tax considerations were not the primary motivation of the subject transactions:

> There is no argument in this case that more tax was saved in any country or countries other than in Canada and that the primary purpose was not, therefore, to obtain a Canadian tax benefit.[105]

The court's determination of the relative importance of the non-Canadian tax considerations motivating the subject transactions was important to its conclusion

105 Ibid., at paragraph 56.

that section 245 did not apply. In *RMM Canadian Enterprises Inc. et al. v. The Queen*,[106] which dealt with section 245, the Tax Court stated that since the provision operates within the context of Canadian tax law, the primary purpose of a transaction for the purposes of applying the provision should be determined without reference to the taxpayer's foreign tax-avoidance motivations. In *Univar*, the court rejected the argument that *RMM Canadian Enterprises* "stands for the proposition that an analysis of the purposes of transactions or events outside Canada should not be considered by this Court."[107]

While the court's determination in *Univar* that the subject transactions had a primary non-Canadian tax motivation seemed relevant to its conclusion that section 245 did not apply, it seems reasonable to conclude that this determination might also have been part of the rationale for the court's conclusion that paragraph 95(6)(b) did not apply; it may certainly be argued that where a taxpayer's transactions have a primary Canadian tax motivation, the court's approach to paragraph 95(6)(b) might be different.

Thus, some aspects of *Univar* support our analysis of the potential application of paragraph 95(6)(b) and others do not, with the result that the proper interpretation of paragraph 95(6)(b) remains unclear. The central issue in the pending tax litigation dealing with paragraph 95(6)(b), and one that was not clearly addressed in *Univar*, is the proper scope of the purpose test in the provision. For the most part, we believe that *Univar* supports our conclusion that in the application of paragraph 95(6)(b), it is the principal purpose of the subject share acquisition only that is relevant, not the series of transactions that includes the share acquisition. In *Univar*, the court focused on the principal purpose of the acquisition of the Barbadosco shares, and not on the purpose of the series of transactions that included the acquisition. However, the central finding of fact in *Univar* on which the decision was based was that there was no alternate transaction the Canadian tax on which had been avoided, reduced, or deferred. To the extent that the court dealt with the purpose of the share acquisition, its comments are obiter and may not carry significant weight in future court decisions.

SUMMARY: TAKING STOCK OF PARAGRAPH 95(6)(b)

It is our strongly held view that paragraph 95(6)(b) should have no application to most acquisitions of shares of a foreign corporation when the acquiror has a substantial interest in the foreign corporation and reasonably expects to receive either substantial dividends on the shares or long-term capital appreciation from holding the shares. This view is based on our belief that the proper focus of the principal purpose test in the provision should be the share acquisition itself, determined on an objective basis, without reference to the purpose of the series of transactions that includes the share acquisition.

106 97 DTC 302 (TCC).

107 *Univar*, supra note 26, at paragraph 59.

As we have seen, in its draft ITTN the CRA asserts that various financing structures, which the CRA believes are entered into primarily for tax-avoidance purposes, are offensive, and that it is therefore appropriate to invoke paragraph 95(6)(b) to ignore a share acquisition that would otherwise result in the issuing corporation having foreign affiliate status in relation to a Canadian corporation. On the CRA's reading of paragraph 95(6)(b), an acquisition of the shares of a foreign affiliate by a Canadian corporation is potentially subject to paragraph 95(6)(b) if the series of transactions of which the acquisition is a part has a primary tax purpose that involves the avoidance, reduction, or deferral of tax otherwise payable. The CRA's approach to paragraph 95(6)(b) seems to be based on its view that on a textual interpretation of the provision, there is only one reasonable reading: the provision applies to deem most acquisitions of the shares of a foreign affiliate not to have occurred.

On the basis of the CRA's interpretation, paragraph 95(6)(b) applies to many seemingly benign acquisitions of the shares of a foreign affiliate. The incorporation by a Canadian corporation of a foreign branch that has become profitable is a simple example that comes to mind. From the predictable abyss that such a sweeping interpretation would create, the CRA retreats by proposing to read into the provision an "abusive tax avoidance" condition that must be met before it will apply paragraph 95(6)(b) in a particular case. It is in that determination that the CRA, on the basis of its reading of extrinsic aids, has identified "Canadian competitiveness and growth" as an overarching policy objective of the foreign affiliate rules. The CRA's position is that where the objective is not met, paragraph 95(6)(b) will apply. Thus, where an acquisition of the shares of a foreign affiliate or the series of transactions of which the acquisition is a part do not meet this objective, the CRA concludes that paragraph 95(6)(b) will apply to permit the acquisition to be ignored for the purposes of the foreign affiliate rules. If a particular transaction or series meets this objective, the CRA will, by administrative fiat, not apply paragraph 95(6)(b). A determination that the provision applies in the case of a particular acquisition of shares of a foreign affiliate by a Canadian corporation is tantamount to the CRA using extrinsic aids as the basis for denying section 113 deductions in respect of dividends on the shares.

The CRA's dubious use of extrinsic aids to warrant its non-application of paragraph 95(6)(b) encapsulates what is fundamentally wrong with its interpretation of paragraph 95(6)(b) and why that interpretation should be rejected. The CRA is effectively putting the cart before the horse: instead of looking to extrinsic aids to identify a perceived policy basis on which to justify the non-application of paragraph 95(6)(b) in circumstances where its interpretation of the provision would dictate that it applies, the CRA should seriously question the veracity of an interpretation of paragraph 95(6)(b) that makes such an exercise necessary in the first place.

In *Canada Trustco*, the Supreme Court confirmed that in interpreting a tax provision, a textual interpretation plays a "dominant role in the interpretive process" where the words of the provision are "precise and unequivocal."[108] That is, while

108 *Canada Trustco*, supra note 24, at paragraph 10.

the contextual and purposive analyses of the provision are not irrelevant, the ordinary meaning of the words is dominant in the interpretation when that meaning is plain. For all the reasons set out earlier in this article, we believe that the language of paragraph 95(6)(b) is clear and that there is only one reasonable reading—namely, that the proper focus of the provision is the purpose of the acquisition of the shares of the foreign affiliate and nothing more. In a case where the shares represent a real investment from which the holder will derive substantial dividends or long-term capital appreciation, the required primary tax purpose is not met and the provision has no application to such an acquisition.

In the structures described in the draft ITTN, as we have argued above, it is the interest deduction on the funds borrowed in Canada (or the fact that the Canadian corporation has used surplus funds to make the investment and thus no longer earns income that is taxable in Canada on such funds) that generates the tax savings. The acquisition of the shares of the affiliate does not, in and of itself, result in an avoidance, reduction, or deferral of tax under the Act.

Further, where subparagraph 95(2)(a)(ii) operates to recharacterize interest received by the affiliate as active business income,[109] dividends can be paid by the affiliate to the Canadian corporation without further Canadian tax; however, this result is due to the characterization of the activities of the affiliate under the relevant rules in the Act, not to the acquisition or holding of the shares of the lending affiliate per se.

Therefore, so long as the proper focus is on the purpose of the acquisition of the shares itself and not on the purpose of some other transaction or the series of transactions of which the acquisition is a part, we believe that paragraph 95(6)(b) should not apply to most acquisitions of shares of a non-resident corporation by a person or partnership when the shares are acquired for the purpose of earning substantial dividends or long-term capital appreciation.

Although we do not believe it be the case, we considered whether the language of paragraph 95(6)(b) describing the purpose test might support two reasonable interpretations of paragraph 95(6)(b)—the interpretation that we have advanced in this article and that of the CRA that is reflected in the draft ITTN. In determining the proper interpretation of a tax provision, where the words of the provision are not clear and unequivocal and "can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role."[110] In such cases, the contextual and purposive analysis will be given more weight in determining the proper interpretation of the provision. In this connection, extrinsic aids may be used to assist in determining the proper interpretation of the provision. If, on a textual analysis, it is determined that the ordinary meaning of paragraph 95(6)(b) is not as clear and unequivocal as

109 Or where the affiliate has other sources of active business income out of which to fund dividends, as in the case where Canco simply subscribes for preferred shares of a related foreign corporation and that corporation earns active business income that is added to its exempt surplus.

110 *Canada Trustco*, supra note 24, at paragraph 10.

we believe it to be, it will remain to determine the proper interpretation of the provision on the basis of a contextual and purposive analysis.

For the reasons discussed in detail in this article, on a contextual and purposive analysis of paragraph 95(6)(b), the CRA has not made a case to support the interpretation that it argues for.