GAAR in the Tax Court After Canada Trustco: A Practitioner’s Guide

Brian Kearl and Bruce Lemons*

PRÉCIS
Cet article porte sur l’interprétation et l’application de la règle générale anti-évitement (RGAÉ) par la Cour canadienne de l’impôt depuis la première incursion de la Cour suprême du Canada dans le débat sur la RGAÉ dans les arrêts Hypothèques Trustco Canada et Kaulius. Plus précisément, les auteurs ont exploré les arrêts de la Cour canadienne de l’impôt qui ont suivi pour en dégager les tendances émergentes, la constance dans les motifs des juges et les lignes directrices dont peuvent s’inspirer les fiscalistes pour élaborer et mettre en œuvre des stratégies de planification fiscale pour leurs clients. Cette série de décisions a réservé une surprise, à savoir le degré de succès des contribuables à l’étape de l’« opération d’évitement » lors de l’application des critères de la RGAÉ : Evans, Overs, MIL Investments, McMullen et MacKay ont tous été favorables au contribuable à cette étape. Ces arrêts ainsi que l’arrêt Univar montrent une tendance de la Cour canadienne de l’impôt à établir une série de normes prévisibles pour interpréter la RGAÉ, conformément à la préférence exprimée par la Cour suprême du Canada pour la certitude, la cohérence et la prévisibilité dans l’application de la règle. Cependant, quatre autres jugements — Desmarais, Lipson, CECO et Copthorne — s’écartent, à des degrés divers, de l’approche directive étroite retenue par la Cour canadienne de l’impôt. Les auteurs concluent que la Cour canadienne de l’impôt dégage des normes additionnelles d’interprétation de la RGAÉ qui, selon eux, aideront les fiscalistes à naviguer dans les eaux parfois troubles des stratégies de planification fiscale complexes dans l’environnement postérieur à Hypothèques Trustco.

ABSTRACT
This article considers the interpretation and application of the general anti-avoidance rule (GAAR) by the Tax Court of Canada since the Supreme Court of Canada first waded into the GAAR debate in Canada Trustco and Kaulius. More specifically, the authors have mined the post-Canada Trustco decisions of the Tax Court for emerging trends, uniformity in the judges’ decisions, and guidance for tax practitioners in developing and implementing tax plans for their clients.

* Brian Kearl, formerly of Olson Lemons LLP, Calgary, is a tax associate with Gowling Lafleur Henderson LLP, Calgary; Bruce Lemons is a tax consultant to Olson Lemons LLP. The authors would like to thank Thomas Olson of Olson Lemons LLP, Calgary, for his comments on this article.
One surprise in this series of decisions is the level of success enjoyed by taxpayers at the “avoidance transaction” stage of the GAAR test: Evans, Overs, MIL Investments, McMullen, and MacKay were all decided in the taxpayer’s favour at that stage. These cases, along with Univar, show an inclination on the part of the Tax Court to establish a set of predictable standards for the interpretation of GAAR, in accordance with the Supreme Court’s preference for certainty, consistency, and predictability in the application of the provision. However, four other decisions—Desmarais, Lipson, CECO, and Copthorne—represent, to differing degrees, a departure by the Tax Court from a narrow guideline approach.

The authors conclude that additional standards of GAAR interpretation are emerging in the Tax Court, which, in their view, will assist tax practitioners in the post-Canada Trustco environment in navigating the often uncertain waters of complex tax planning.

**KEYWORDS:** GENERAL ANTI-AVOIDANCE RULE • GAAR • STATUTORY INTERPRETATION • TAX PLANNING

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[E]veryone in this country is entitled to arrange his or her affairs . . . or his or her company’s affairs to avoid taxes, to minimize the impact of taxes. That is lesson number one in law school and accounting school. Tax avoidance is an expectation on the part of the government and taxpayers are entitled to arrange their affairs accordingly.

The Honourable John McKay, Parliamentary Secretary to the Minister of Finance, House of Commons, Debates, December 14, 2004, 2746

INTRODUCTION

The Income Tax Act contains all manner of “shoals and traps,” making tax planning an often challenging test of practitioners’ navigational skills. The most notable of these shoals and traps is section 245, commonly referred to as the general anti-avoidance rule or GAAR.

The Supreme Court of Canada has emphasized that the intention of Parliament in respect of the Act generally, and GAAR specifically, is to maintain certainty and/or consistency, predictability, and fairness. In its first two decisions pertaining to GAAR, Canada Trustco and Kaulius, the court recognized that the interpretation of GAAR that best realizes Parliament’s intention is one that limits the general anti-avoidance rule to a provision of “last resort.” However, the court also recognized that the application of GAAR is an inherently factual exercise. One might therefore expect that the application of GAAR by the lower courts, following Canada Trustco, would be susceptible to some uncertainty, inconsistency, and unpredictability, despite the Supreme Court’s expressed preference to the contrary. This has indeed proved to be the case.

This article examines the application of GAAR by the Tax Court of Canada in cases decided since the Supreme Court’s judgment in Canada Trustco. This examination will show that the Tax Court’s decisions in these cases are more uniform than its earlier GAAR decisions; however, the post–Canada Trustco decisions do demonstrate a degree of inconsistency. A number of these later judgments reflect the Tax

1 Geransky v. The Queen, [2001] 2 CTC 2147, at paragraph 42 (TCC); and Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

2 See, in particular, The Queen v. Canada Trustco Mortgage Co., [2005] 5 CTC 215, at paragraphs 1, 12, 31, 42, 50, and 61 (SCC). For example, the court states, at paragraph 12, “The 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”; and, at paragraph 31, “Despite Parliament’s intention to address abusive tax avoidance by enacting the GAAR, Parliament nonetheless intended to preserve predictability, certainty and fairness.”

3 Supra note 2.

4 Sub nom. Mathew v. The Queen, [2005] 5 CTC 244 (SCC) (herein referred to as Kaulius).

5 Canada Trustco, supra note 2, at paragraph 21.

6 In Canada Trustco, supra note 2, the court highlighted the factual nature of each stage of the GAAR analysis—namely, the tax benefit inquiry (at paragraph 19), the avoidance transaction inquiry (at paragraph 29), and the abusive tax avoidance inquiry (at paragraph 44).
Court’s inclination to establish a set of standards for the interpretation of GAAR, in accordance with the Supreme Court’s emphasis on certainty, consistency, and predictability. Other decision represent, to differing degrees, a departure from a narrow guideline approach.

In any event, it is clear that additional standards of GAAR interpretation are emerging from the Tax Court’s rulings in recent cases. These, we believe, will be helpful to practitioners in negotiating the technical hazards of complex tax planning following the Supreme Court’s decision in Canada Trustco.

THE GENERAL ANTI-AVOIDANCE RULE

GAAR applies where a taxpayer (1) enjoyed a “tax benefit,” (2) entered into an “avoidance transaction,” and (3) engaged in abusive tax avoidance. All of the foregoing “tests” must be met before GAAR will apply.

A “tax benefit,” as defined in subsection 245(1), means

a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty.

An “avoidance transaction,” as defined in subsection 245(3), means any transaction

(a) that, but for this section, would result, directly or indirectly, 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; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, 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.

Under subsection 245(4), abusive tax avoidance exists where the impugned transaction(s) would result directly or indirectly in a misuse of the provisions of the Act or an abuse of the Act read as a whole.

THE SUPREME COURT SPEAKS ON GAAR

In Canada Trustco, the Supreme Court outlined the approach to be taken in deciding GAAR cases. This approach has been heavily cited by the Tax Court in subsequent GAAR decisions. It was summarized in Canada Trustco as follows:

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7 See Evans, infra note 18, at paragraph 13; McMullen, infra note 22, at paragraph 32; MacKay, infra note 23, at paragraph 54; Desmarais, infra note 24, at paragraph 16; and Copthorne, infra note 27, at paragraph 26.
1. Three requirements must be established to permit application of the GAAR:

   (1) A tax benefit resulting from a transaction or part of a series of transactions (s. 245(1) and (2));
   
   (2) that the transaction is an *avoidance transaction* in the sense that it cannot be said to have been reasonably undertaken or arranged primarily for a *bona fide* purpose other than to obtain a tax benefit; and
   
   (3) that there was *abusive tax avoidance* in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

2. The burden is on the taxpayer to refute (1) and (2), and on the Minister to establish (3).

3. If the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.

4. The courts proceed by conducting a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the context of the whole Act.

5. Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s. 245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance. The central issue is the proper interpretation of the relevant provisions in light of their context and purpose.

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.

7. Where the Tax Court judge has proceeded on a proper construction of the provisions of the *Income Tax Act* and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.8

In applying GAAR, the Supreme Court recognized and reaffirmed the *Duke of Westminster* principle that taxpayers are entitled to arrange their affairs to minimize their taxes,9 with only a slight modification for GAAR. The Honourable John McKay (quoted in the epigraph to this article) was merely restating this principle in 21st-century terms when he said, “Tax avoidance is an expectation on the part of the government and taxpayers are entitled to arrange their affairs accordingly.”

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8 *Canada Trustco*, supra note 2, at paragraph 66.

In support of the tax-minimization policy of the Act, the Supreme Court characterized GAAR as a provision of “last resort,” noted that it can be applied only where “the abusive nature of the transaction is clear,” and mandated that any doubt as to the application of GAAR is to be resolved in favour of the taxpayer. The court explained the rationale for these conditions as follows:

The taxpayer, once he or she has shown compliance with the wording of a provision, should not be required to disprove that he or she has thereby violated the object, spirit or purpose of the provision. It is for the Minister who seeks to rely on the GAAR to identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated, when the provisions of the Act are interpreted in a textual, contextual and purposive manner. The Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.

Furthermore, as noted above, the Supreme Court recognized that the policy of the Act generally, and GAAR specifically, is to ensure certainty, consistency, predictability, and fairness for taxpayers as they arrange their affairs. Again, the following statements highlight the court’s rationale for endorsing these policy objectives:

Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe. . . .

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.

Parliament intends taxpayers to take full advantage of the provisions of the Income Tax Act that confer tax benefits. Indeed, achieving the various policies that the Income Tax Act seeks to promote is dependent on taxpayers doing so.

The court therefore chose to limit the scope and application of GAAR in three ways: (1) by limiting the application of GAAR to the clearest of cases, rather than those in which an abuse is more probable than not; (2) by resolving any doubt in favour

10 Canada Trustco, supra note 2, at paragraph 21.
11 Ibid., at paragraph 50.
12 Ibid., at paragraph 66, item 3.
13 Ibid., at paragraph 65.
15 Canada Trustco, supra note 2, at 31.
of the taxpayer, rather than by merely applying a test of reasonableness; and (3) by requiring the minister to establish abusive tax avoidance, rather than requiring the taxpayer to disprove the minister’s allegation. Logically, the court’s approach makes it more likely that certainty, consistency, predictability, and fairness will be achieved.

**TAX COURT DECISIONS AFTER CANADA TRUSTCO**

Given the Supreme Court’s stated preference that a large measure of deference be accorded to the Tax Court’s decisions on GAAR, and given that the application of GAAR is an inherently factual exercise, one would expect at least some inconsistency and unpredictability in the decisions of the Tax Court in a post-Canada Trustco world. Since Canada Trustco, the Tax Court has considered the application of GAAR in 10 cases. Of these cases, Evans, Overs, Univar, MIL Investments, McMullen, and MacKay seem to show the Tax Court’s willingness to limit the scope and application of GAAR in accordance with the policies underlying Canada Trustco. Unfortunately, Desmarais, Lipson, CECO, and Copthorne represent a departure from this trend and evidence a much more intrusive interpretation of GAAR than one would have thought the Supreme Court mandated.

However one views these cases, they do reveal certain important principles that will clearly assist tax practitioners in developing GAAR-resistant tax plans.

**“Tax Benefit”**

With respect to the existence of a “tax benefit,” the Supreme Court in Canada Trustco stated:

> If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. In some other instances, it may be that

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16 Ibid., at paragraph 66, item 7.
17 See supra note 6.
18 Evans v. The Queen, [2006] 2 CTC 2009 (TCC).
19 Overs v. The Queen, [2006] 3 CTC 2255 (TCC).
20 Univar Canada Ltd. v. The Queen, [2006] 1 CTC 2308 (TCC).
21 MIL (Investments) SA v. The Queen, [2006] 5 CTC 2552 (TCC).
22 McMullen v. The Queen, [2007] 2 CTC 2463 (TCC).
23 MacKay et al. v. The Queen, 2007 DTC 425 (TCC). The minister has appealed this decision to the Federal Court of Appeal.
24 Desmarais v. The Queen, [2006] 3 CTC 2304 (TCC).
25 Lipson v. The Queen, [2006] 3 CTC 2494 (TCC); aff’d. [2007] 3 CTC 100 (FCA); leave to appeal to the Supreme Court of Canada granted, SCC file no. 32041 (and SCC file no. 34042 for the companion case Jordan B. Lipson v. The Queen).
26 CECO Operations Ltd. v. The Queen, [2006] 5 CTC 2174 (TCC).
27 Copthorne Holdings Ltd. v. The Queen, 2007 TCC 481.
the existence of a tax benefit can only be established by comparison with an alternative arrangement.\textsuperscript{28}

Of the 10 GAAR cases subsequently decided by the Tax Court, only in \textit{Univar} and \textit{Copthorne} has the court been required to undertake a thorough analysis of the existence of a tax benefit.

\textbf{\textit{Univar}}\textsuperscript{29}

In \textit{Univar}, the appellant, a wholly owned subsidiary of a US-resident corporation (“UC”), used its excess cash and proceeds from a loan to capitalize a Barbados foreign affiliate (“Barbadosco”). Barbadosco then used these funds to acquire certain intercorporate debt obligations held by other members of the Univar corporate group—in particular, debt owed to UC by its European subsidiary (“UE”). As a resident of Barbados, the foreign affiliate of Univar was subject to a relatively low rate of corporate tax on its income from these intercorporate debt obligations. Also, because Barbados is a treaty country, for Canadian tax purposes, the foreign affiliate’s income was considered to be income from an active business. Therefore, all the dividends paid by Barbadosco to Univar were from exempt surplus and entitled Univar to a deduction pursuant to paragraph 113(1)(a).

Univar asserted, and the court seemed to agree, that the purposes of these transactions were as follows: (1) to adequately leverage Univar and utilize its excess cash reserves; (2) to maximize Univar’s rate of return on its excess cash reserves and the funds from its debt obligations; (3) to remove certain intercorporate debt obligations from other members of the Univar corporate group; and (4) to resolve certain US income tax issues applicable to the Univar corporate group.

All of these objectives were satisfied by the series of transactions entered into by Univar. Bell J accepted Univar’s argument that in the circumstances these objectives could not have been achieved by having Univar acquire the intercorporate debt obligations directly:

\begin{quote}
[T]he evidence of Pruitt, Lundberg and Tole was clear that no consideration was ever given to the Appellant acquiring the notes receivable itself because that would not have resolved any problem.\textsuperscript{10}
\end{quote}

On the basis of this finding of fact, Bell J denied the minister’s attempt to establish a tax benefit by way of comparing the different tax consequences that would have resulted if the intercorporate debt had been acquired by Univar instead of the foreign affiliate. Bell J rightly determined that because direct acquisition of the intercorporate debt by Univar was never an option, it was not a proper alternative transaction to consider:

\begin{flushright}
\textsuperscript{28} \textit{Canada Trustco}, supra note 2, at paragraph 20.
\textsuperscript{29} Supra note 20.
\textsuperscript{30} Ibid., at paragraph 30.
\end{flushright}
Throughout the appeal, the Respondent’s cross-examination of Pruitt, Lundberg and Tole and the Respondent’s submissions clung to the hypothetical situation of the Appellant having acquired the debt owing by UE to UC as an “alternative arrangement.” Each of Pruitt, Lundberg and Tole were, without doubt, credible. . . . The evidence of all three . . . witnesses was clear that there was never any intent for Univar to acquire the debt and, in fact, Univar did not acquire that debt. It was acquired by Barbadosco with monies used by Univar to subscribe for shares of Barbadosco.31

Noting that “the Respondent’s case . . . is built solely upon the hypothetical premise that the debt of UE to UC was purchased by Univar, not by Barbadosco,”32 Bell J rejected the minister’s attempt to recharacterize the actual transactions entered into by Univar in order to establish a tax benefit:

The Respondent clearly cannot recharacterize what, in fact, happened in assuming that the Appellant purchased the aforesaid notes. That is simply not in accordance with the evidence of three credible witnesses for the Appellant. The attempted recharacterization is not an appropriate alternative arrangement to establish tax otherwise payable.33

Bell J went on to hold that Univar did not enjoy a tax benefit:

The only alternate arrangement that can be considered is the possibility of the alleged avoidance transaction not having occurred. Had the shares of Barbadosco not been acquired by the Appellant, there would be no tax otherwise payable which could be avoided, reduced or deferred. The acquisition of such shares by the Appellant does not change that.34

In light of the foregoing, we can conclude that if the minister attempts to establish a tax benefit by recharacterizing the actual transaction as some alternative arrangement,35 the alternative arrangement must be capable of accomplishing all of the objectives of the taxpayer. If the minister’s proposed arrangement would not achieve all of the taxpayer’s objectives, it cannot be the basis for a tax benefit challenge.

Copthorne36
The facts in Copthorne are mesmerizingly complex, even for a tax case, and it is hazardous to summarize them. Nevertheless, we must attempt to do so—or double the size of this article.

31 Ibid., at paragraph 37.
32 Ibid., at paragraph 38.
33 Ibid., at paragraph 42.
34 Ibid., at paragraph 43.
35 See Canada Trustco, supra note 2, at paragraph 20.
36 Supra note 27.
Copthorne is a tale of two chains of corporations, both owned by non-residents of Canada ("the Li family"). In one of the chains ("chain 1"), a Canadian subsidiary ("Copthorne I") of a foreign corporation ("Big City") sold a hotel in 1989 at a substantial gain ("the 1989 gain"). Because Copthorne I had paid-up capital (PUC) of only $1, the distribution of the proceeds from the sale of the hotel would have resulted in withholding tax. Apparently for this reason, Copthorne I invested the proceeds in a foreign subsidiary ("COIL") that traded bonds offshore. Under the provisions of the Act then in effect, the gains from the trading activity were not taxable in Canada.

In the other chain of corporations ("chain 2"), the Li family invested over $96 million in a Canadian company ("VHHC Investments"), resulting in over $96 million of PUC. VHHC Investments in turn invested over $67 million in a subsidiary ("VHHC Holdings"), resulting in over $67 million of PUC with respect to VHHC Holdings. (This "doubling up" of PUC for the same invested funds dropped down into a subsidiary is not unusual; it is a consequence of the operation of the definition of "paid up capital" in subsection 89(1).) VHHC Holdings then organized a subsidiary ("VHSUB"). VHSUB traded principally in a single stock that resulted in significant capital losses. All of these transactions occurred after the 1989 gain arose and, apparently, were unrelated to the activity that occurred in chain 1.

In 1992, in an effort to utilize the capital losses accrued in VHSUB against the 1989 gain realized by Copthorne I, and to simplify the corporate structure, VHHC Investments sold its interest in VHHC Holdings to Copthorne I for $1,000. While the fair market value of the shares in VHHC Holdings was only $1,000, the PUC in these shares (as noted) totalled over $67 million.

In 1993, Copthorne I sold its shares in VHHC Holdings to Big City for $1,000 ("the 1993 share sale"). As a result, Big City was now the parent of both Copthorne I and VHHC Holdings. The shares of VHHC Holdings had a fair market value of $1,000 and PUC of over $67 million.

In 1994, Big City caused Copthorne I and VHHC Holdings (along with two other Canadian corporations) to be amalgamated into Copthorne Holdings Ltd. ("Copthorne II"). This completed the first series of transactions at issue in the case.

The effect of the amalgamation resulting in Copthorne II was that the capital loss in VHHC Holdings could be carried back and applied against the 1989 gain realized by Copthorne I. Furthermore, because the reorganization resulting in Copthorne II was a horizontal (not vertical) amalgamation, Big City's PUC in Copthorne II was equal to $1 in respect of its shares in Copthorne I and over $67 million in respect of its shares in VHHC Holdings. If the amalgamation had occurred when Copthorne I owned VHHC Holdings, the $67 million of PUC in the VHHC Holdings shares would have been eliminated.

In 1994, and subsequent to the amalgamation resulting in Copthorne II, the Department of Finance released its revisions to the foreign accrual property income (FAPI) rules. The effect of these revisions was that the investment income earned in COIL would now be considered FAPI and be taxable in Canada. The Li family therefore decided to dispose of their investment in COIL and move the proceeds of disposition
outside Canada. The family also decided to further simplify their Canadian holdings and consolidate their Canadian investments.

At the end of 1994, the shares in VHHC Investments (the Canadian parent company of chain 2) were transferred to L.F. Investments, a new Barbados corporation owned by the Li family. Big City (the foreign parent company of chain 1) also sold its interest in Copthorne II to L.F. Investments. As a result, L.F. Investments now owned all of the shares in Copthorne II, with its PUC of over $67 million, and all of the shares in VHHC Investments, with its PUC of over $96 million. It is important to remember that the same contribution that gave rise to the $96 million of PUC with respect to VHHC Investments also gave rise to the $67 million of PUC relative to Copthorne II, the successor to VHHC Holdings.

At the beginning of 1995, Copthorne II and VHHC Investments (and two other Canadian corporations) were amalgamated into Copthorne Holdings Ltd. (“Copthorne III”). Immediately following this amalgamation, Copthorne III redeemed approximately 70 percent of its shares held by L.F. Investments for over $142 million. Because the aggregate PUC of the shares in Copthorne III was over $164 million (as computed by the appellant), Copthorne III did not withhold any tax under part XIII of the Act. This completed the second series of transactions at issue in the case.

Later, in 2002, Copthorne III amalgamated with five other companies into Copthorne Holdings Ltd. (“Copthorne IV”), the appellant.

Taking exception to the results of the foregoing transactions, the minister reassessed Copthorne IV and levied withholding tax in respect of the redemption proceeds ($142 million) in excess of the PUC attributable to VHHC Investments ($96 million). The minister also applied a 10 percent withholding tax penalty against Copthorne IV for failing to withhold and remit the part XIII tax.

The minister’s reassessment was based on GAAR. According to the minister, the applicable tax benefit was the avoidance of the withholding tax. The avoidance transaction was the 1993 share sale of VHHC Holdings to Big City. The abusive tax avoidance was the misuse of the PUC calculation provisions of the Act.

In the decision of the Tax Court, significantly, Campbell J did not claim that the problem was that the Li family had caused the VHHC Investments chain of corporations (chain 2) to “manufacture” PUC through the establishment of a subsidiary for the purpose of being able to extract earnings offshore in chain 1. Given the temporal disconnect between the 1989 gain and the formation and establishment of VHHC Investments and its subsidiaries, this was a correct approach.

While Campbell J recognized that “neither the 1993 Share Sale, nor the preservation of PUC resulted in a direct reduction, avoidance or deferral of tax in 1993,”37 she nevertheless found that Copthorne IV enjoyed a tax benefit. Taking the “alternative arrangement” route, Campbell J determined that had the 1993 share sale of VHHC Holdings to Big City not occurred, the PUC of $67 million in the shares in VHHC Holdings would have been eliminated in an amalgamation with Copthorne I and

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37 Ibid., at paragraph 47.
would not have been ultimately available for tax-free distribution to L.F. Investments by Copthorne III.

Unless Copthorne IV had reasons for entering into the first series of transactions other than loss utilization and corporate structure simplification, both of which could have been achieved without the 1993 share sale, Campbell J’s alternative transaction analysis here is likely correct.

Summary
In respect of most tax plans, the existence of a tax benefit will be clear. As a result of the tax plan, there will virtually always be a reduction, avoidance, or deferral of taxes. However, where the minister cannot find an explicit tax benefit and attempts to establish a tax benefit by way of an alternative arrangement (as the minister is entitled to do), the existence of a tax benefit will not be so certain.

In Univar, the appellant was successful in demolishing the minister’s assumption of a tax benefit because the minister’s alternative arrangement would not have achieved Univar’s objectives in entering into the impugned transactions. Conversely, in Copthorne, the appellant was unsuccessful at the tax benefit stage of the GAAR analysis because the minister’s alternative arrangement apparently would have achieved all of Copthorne IV’s objectives in respect of the impugned transactions.

In the rare case in which no clear tax benefit would arise from a transaction or series of transactions, but the intended arrangement may nevertheless be susceptible to a GAAR challenge, tax practitioners should thoroughly analyze any potential alternative arrangements to determine whether all of the taxpayer’s objectives would be met or satisfied if such alternative arrangements were completed instead of the impugned transactions. It is also good practice—not only in such cases but generally—for tax advisers to document all the bona fide objectives and reasons for the proposed transactions, in order to establish the basis for undertaking those transactions, to eliminate potential alternative arrangement arguments, and to fortify avoidance transaction defences, if required.

“Avoidance Transaction”
On the question of whether a taxpayer employed an “avoidance transaction,” the Supreme Court in Canada Trustco stated:

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.38

The expression “non-tax purpose” has a broader scope than the expression “business purpose.” For example, transactions that may reasonably be considered to have been

38 Canada Trustco, supra note 2, at paragraph 27.
undertaken or arranged primarily for family or investment purposes would be immune from the GAAR under s. 245(3). Section 245(3) does not purport to protect only transactions that have a real business purpose. Parliament wanted many schemes that do not have any business purpose to endure. . . .

If at least one transaction in a series of transactions is an “avoidance transaction,” then the tax benefit that results from the series may be denied under the GAAR. This is apparent from the wording of s. 245(3). Conversely, if each transaction in a series was carried out primarily for bona fide non-tax purposes, the GAAR cannot be applied to deny a tax benefit.39

Subsequent to Canada Trustco, the Tax Court has been extremely active in interpreting, refining, and applying subsection 245(3). Taxpayers have successfully defeated GAAR attacks at the avoidance transaction stage in Evans, Overs, MIL Investments, McMullen, and MacKay. Furthermore, in Univar, where the court found that the taxpayer did not enjoy a tax benefit, Bell J stated that if he had also been required to address the avoidance transaction question, he would have held that none existed.40

Evans41

In Evans, the appellant maintained that the primary, non-tax purpose of the transactions entered into was to transfer wealth to three of his children.42 To that end, the appellant (Dr. Evans) sold approximately $500,000 worth of shares in an operating corporation to a partnership formed by his spouse and three of his children. Dr. Evans claimed a capital gains deduction to shelter the capital gain realized on the sale of the shares.

The partnership purchased the shares with debt, evidenced by a promissory note issued to Dr. Evans. The partnership made interest and principal payments on this note with proceeds that it received from declared dividends on the shares and on share redemptions. The members of the partnership included this dividend and deemed dividend income in their taxable income in the appropriate years and also claimed their respective shares of the interest expense incurred on the note. Dr. Evans reported the interest income that he received on the note in his income tax return.

The effect of these transactions was to shift dividend income from Dr. Evans, a high-tax-bracket taxpayer, to his children, who paid little or no tax on the dividend income, while Dr. Evans’s capital gain was sheltered by his capital gains deduction.

39 Ibid., at paragraphs 33-34.
40 Supra note 20, at paragraph 48.
41 Supra note 18.
42 According to facts admitted by the minister, this purpose was achieved to the extent of $50,000 by the end of 1998. Although this fact was admitted, both at discovery and in the partial statement of agreed facts (paragraph 49) appended to the decision, the court mistakenly found that no wealth had been transferred: Evans, supra note 18, at paragraph 19. Note that the taxation years in issue (1997 through 1999) preceded the introduction of section 120.4, which specifically targeted income-splitting arrangements such as that disputed in the Evans case.
The minister argued that the result of the transactions was essentially to allow Dr. Evans to strip surplus out of the corporation, analogous to RMM\textsuperscript{43} and McNichol.\textsuperscript{44} However, Bowman CJ agreed with counsel for Dr. Evans,\textsuperscript{45} that RMM and McNichol were distinguishable on both factual and legal grounds, and that the transaction constituted a legally permissible form of income splitting,\textsuperscript{46} rather than surplus stripping.

Bowman CJ determined that the “avoidance transaction” part of GAAR had not been established because the overall purpose of the transactions was not primarily tax-motivated, though the method of achieving that purpose was tax-effective.\textsuperscript{47} He stated:

I find as a matter of fact that the primary purpose of the series of transactions with which we are concerned here was to put the corporate funds in Dr. Evans’ hands. The method chosen was one designed to enable him to do so at the least tax cost. I emphasize the words of the Explanatory Notes adopted by the Supreme Court of Canada in paragraph 30 of \textit{Canada Trustco}:

Subsection 245(3) does not permit the “recharacterization” of a transaction for the purposes of determining whether or not it is an avoidance transaction. In other words, it does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes.

This is what I think the Crown is doing here.\textsuperscript{48}

Tax practitioners, when devising and implementing tax plans, must not neglect the commercial, business, family, investment, or other non-tax purposes of the plan. Where a tax plan has an overall non-tax purpose, and that purpose is solidified and supported by documentation that follows the plan and by the behaviour of the plan participants, \textit{Evans} may be cited in rebuttal to the minister’s avoidance transaction position.\textsuperscript{49}

\textsuperscript{43} RMM Canadian Enterprises Inc. \textit{v.} The Queen, [1998] 1 CTC 2300 (TCC).

\textsuperscript{44} McNichol \textit{v.} The Queen, [1997] 2 CTC 2088 (TCC).

\textsuperscript{45} Evans, supra note 18, at paragraph 34.


\textsuperscript{47} Evans, supra note 18, at paragraph 20.

\textsuperscript{48} Ibid., at paragraphs 22-23.

\textsuperscript{49} Ibid. Bowman CJ commented (at paragraph 3) on the “complexity and the high level of tax sophistication” of the tax plan and (at paragraph 11) on its “carefully, indeed meticulously, executed” implementation. The clear implication is that the victory for the taxpayer in \textit{Evans} is attributable, in part, to the documentation that followed the plan and the implementation of all the necessary steps of the plan.
In Overs, the appellant sold some of his shares in a closely held corporation to his spouse. In order to pay for the shares, the spouse secured a loan from a bank. This loan was guaranteed by the corporation. The appellant (Overs) used the proceeds from the share sale to pay off an outstanding shareholder loan with the corporation in order to avoid a shareholder benefit income inclusion pursuant to subsection 15(2). The corporation in turn used the proceeds from the shareholder loan to acquire certain investments from the same bank that provided the loan to the spouse, applying these investments as partial security against its guarantee obligations in respect of the spouse’s loan.

When the shares were transferred, Overs and his spouse did not make the election in respect of the rollover available under subsection 73(1). As a result, Overs was not required to include in his income any capital gain realized on the disposition. However, any subsequent income or loss attributable to the shares would be allocated to him pursuant to subsection 74.1(1). Consequently, following the transfer, Overs reported as income all dividends received by his spouse on the shares. Overs also claimed deductions for interest paid on the loan and all guarantee fees paid to the corporation.

The minister disallowed the deduction of the interest and guarantee fees claimed by Overs, relying on GAAR in support of the reassessments. The minister took the position that Overs enjoyed three separate tax benefits from the series of transactions. The first tax benefit was the avoidance of the shareholder benefit income inclusion when Overs paid off his shareholder loan just prior to the corporation’s fiscal year-end. The second tax benefit was the avoidance of the recognition of a capital gain on the disposition of the shares when Overs and his spouse chose not to elect out of subsection 73(1). The third tax benefit was the reduction of tax as a result of the operation of the spousal attribution rules in subsection 74.1(1), whereby the interest and guarantee fees paid by Overs’s spouse were attributed back to Overs.

While finding that Overs did receive a tax benefit because he “claimed a deduction against taxable income,” Little J determined that he did not engage in an avoidance transaction in respect of this or any other tax benefit, because he merely “followed the rules” in subsections 15(2), 73(1), and 74.1(1).

In support of the principle that a transaction can be immunized against GAAR by “following the rules,” reference may be made to this statement by the Supreme Court in Canada Trustco:

Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.

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50 Supra note 19.
51 Ibid., at paragraph 15.
52 Canada Trustco, supra note 2, at paragraph 11.
Following this principle, Bowman CJ in *Evans* noted that the provisions relied upon by the appellant “were used for the very purpose for which they are in the Act.” As a result, in respect of whether there was abusive tax avoidance, Bowman CJ concluded:

I do not think that it can be said that there is an abuse of the provisions of the Act where each section operates exactly the way it is supposed to. The Crown’s position seems to be predicated on the view that since everything worked like clockwork there must have been an abuse. The answer to this position is, of course, that if everything had not worked like clockwork we would not be here.

In light of the foregoing, it seems clear that reliance on specific and detailed provisions of the Act makes GAAR attacks much less likely. In other words, where taxpayers “follow the rules,” relying on provisions that “specif[y] precisely what conditions must be satisfied” and using those provisions “for the very purpose for which they are in the Act,” such that “each section operates exactly the way it is supposed to,” they are entitled to the prescribed results of those provisions.

**MIL Investments**

In *MIL Investments*, the appellant (“MIL”) was a Cayman Islands holding company incorporated by a Canadian resident, Jean-Raymond Bouille. Taking advantage of the tax deferral available under section 85, Bouille transferred his shares in a publicly traded mining company (“DFR”) to MIL. As a result, MIL became a 30 percent minority shareholder in DFR.

DFR discovered a promising mining prospect in Voisey’s Bay, and rolled it into a subsidiary company (“VBN C”). Subsequently, Inco Limited acquired a 25 percent interest in VBN C and some shares in DFR. MIL then transferred some of its shares in DFR to Inco in exchange for Inco shares, obtaining a tax deferral under section 85.1. Following the transfer, MIL was continued into Luxembourg, a tax treaty country with favourable capital gains tax treatment. Shortly thereafter, MIL sold all of its Inco shares and realized a $65 million capital gain that was exempt from tax under the Canada-Luxembourg tax treaty. A month later, MIL sold some of its shares in DFR and realized a $4.5 million capital gain that was also exempt from tax pursuant to the relevant tax treaty.

The following year, one of DFR’s key officers died. Until then, the management and shareholders of DFR had resisted takeover attempts and offers, but in light of this unexpected loss, they agreed to consider takeover options.

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53 Supra note 18, at paragraph 28.
54 Ibid., at paragraph 29.
55 Supra note 21.
Inco proposed to acquire all of the DFR shares. The proposal was accepted, and MIL sold its remaining DFR shares to Inco, realizing a $425 million capital gain and again claiming exemption from tax under the Canada-Luxembourg tax treaty. While the minister did not reassess MIL in respect of its $65 million and $4.5 million capital gains, it did reassess MIL in respect of the $425 million capital gain, relying on GAAR to deny the treaty exemption.

Bell J rejected the minister’s arguments at the avoidance transaction stage of the GAAR analysis. Bell J accepted MIL’s submissions that the purpose of the sale of its Inco shares was to allow Bouille to pay off his debts, and furthermore, that the reason for MIL’s continuance into Luxembourg was that Luxembourg represented a better base of operations from which to conduct its mining operations.

Bell J went on to find, in respect of the impugned transactions, that “the ‘how’ is subordinate to the ‘why’” in determining whether there is an avoidance transaction. In other words, where the overall purpose of the impugned transactions (the “why”) is a bona fide non-tax purpose, the use of tax-efficient transactions (the “how”) to implement this purpose is acceptable. For this reason, “the Appellant having had a bona fide commercial reason for selling, it was open to seek tax advice respecting the appropriate structure for concluding that Sale.” Bell J’s reasoning is consistent with that of Bowman CJ in Evans.

An appeal of this decision by the minister has recently been dismissed by the Federal Court of Appeal. The Court of Appeal refused to overturn Bell J’s finding in respect of whether there was an avoidance transaction, and also determined that a finding of abusive tax avoidance was unwarranted.

As can be seen from both MIL Investments and Evans, a trend appears to be emerging in respect of what constitutes an avoidance transaction. Where the overall purpose (the “why”) of the impugned transactions is not tax-motivated, the fact that such transactions are implemented in a tax-efficient manner (the “how”) will not result in an avoidance transaction. Tax practitioners must therefore pay close attention to the non-tax purposes of tax plans—whether business, investment, familial, or estate planning. Where such purposes are supportable by the evidence, including documentation and the implementation of the plan, taxpayers will likely be protected from successful GAAR attacks.

**McMullen**

In McMullen, the appellant and his business partner each owned 50 percent of the shares in an operating company (“DEL”). DEL owned a heating and air conditioning

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56 Ibid., at paragraph 50.
57 Ibid., at paragraph 54.
58 The Queen v. MIL (Investments) SA, [2007] 4 CTC 235 (FCA).
59 Supra note 22.
business operating in two separate locations. The company was losing money, and the owners disagreed on how to proceed with the business. They decided to split up.

Through a series of transactions, the appellant (McMullen) sold his shares in DEL to a holding company (“114 Co”) owned by his partner’s spouse for a $150,000 note. DEL then paid a $150,000 dividend to 114 Co, which used the funds to pay off the note. The $150,000 dividend was received by 114 Co tax-free, pursuant to section 112. McMullen realized a $50,000 capital gain on the sale of his shares and sheltered the taxable portion, $37,500, by a capital gains deduction pursuant to section 110.6.

McMullen then incorporated a company with his spouse and caused this new company to acquire one of DEL’s two branches. The purchase price was paid for with cash from a bank loan, the assumption of certain liabilities of DEL, McMullen’s outstanding shareholder loan in DEL, and the $150,000 received on the sale of his shares.

Thereafter, McMullen and his spouse, through their company, operated one of the former branches of DEL, and the former partner and his spouse, through DEL, operated the other branch.

The minister sought to reassess McMullen pursuant to the deemed dividend provisions of subsection 84(2) or the connected corporation rules in paragraph 84.1(1)(b), or, alternatively, to deny the tax benefit pursuant to GAAR. Lamarre J rejected the minister’s section 84 and 84.1 arguments, and then considered the arguments in respect of GAAR.

McMullen argued that there were no avoidance transactions because the primary overall purpose of the series of transactions was to separate the single business of DEL into two independently owned businesses. He maintained that the tax planning and the tax-effective transactions were undertaken to support his own independent business goals and those of his former partner.

The minister argued that there was no independent business purpose to the pre-sale share reorganization in DEL, the share sale itself, the $150,000 dividend to 114 Co, or the assignment of the dividend to McMullen. Therefore, the minister recharacterized the $37,500 taxable capital gain, for which McMullen had claimed a capital gains deduction, as a $187,500 taxable dividend.

Lamarre J rejected the minister’s avoidance transaction arguments, finding that all four of the impugned transactions were entered into primarily for non-tax purposes. Lamarre J also rejected the minister’s attempt to establish an avoidance transaction by recharacterizing the impugned transactions:

The Crown tried to recharacterize the sale of shares as a distribution of DEL’s funds on a reorganization of DEL. I have already concluded that there was no reorganization of DEL’s business and that there were [sic] no appropriation of the corporation’s funds by the appellant. The two shareholders severed their relationship and DEL continued operating its business with a new shareholder in place of the appellant. The agreement reached was that the appellant would buy up the Kingston assets. Part of the purchase price was offset by the $150,000 originally declared as a dividend to 114 Co. But there was a consideration for that: the appellant released his shares in DEL, valued at $150,000, in favour of Linda DeBruyn [the partner’s spouse] through 114 Co. I do not
consider this as a tax-free extraction of corporate funds. Rather, I find that this transaction may reasonably be considered to have been arranged primarily for bona fide purposes other than to obtain a tax benefit.\(^{60}\)

Like Bowman CJ in *Evans*, Lamarre J rejected the minister’s attempt to recharacterize the impugned transactions in order to establish an avoidance transaction. Furthermore, the employment of tax-efficient strategies and transactions to achieve non-tax goals did not constitute avoidance transactions under GAAR.

**MacKay\(^{61}\)**

In *MacKay*, the appellant was a member of a partnership that acquired a non-performing mortgage (“the mortgage”) from the National Bank of Canada (“the bank”). The bank had initiated foreclosure proceedings in respect of the mortgage. The mortgage pertained to a shopping centre (“the property”) located in Kamloops, British Columbia. The bank’s adjusted cost base in the mortgage was approximately $16 million. The fair market value of the property was approximately $10 million.

Through a series of transactions, the bank formed a partnership (“the partnership”) along with a subsidiary company and assigned its interest in the mortgage to the partnership. Pursuant to subsection 18(13), the bank did not recognize a capital loss on the transfer of the mortgage to the partnership because it was not dealing at arm’s length with the partnership.

The appellant (MacKay) and other investors then purchased 20 percent of the bank’s interest in the partnership for $2 million. The partnership obtained financing from the bank for $8 million. The partnership used this financing from the bank to redeem the bank’s remaining 80 percent interest in the partnership.

The partnership then finalized the foreclosure proceedings in respect of the mortgage and the property. As a result, the partnership acquired the property and the mortgage was cancelled.

At the end of the partnership’s first fiscal year, the partnership wrote down the adjusted cost base in the property pursuant to subsection 10(1) and recognized a capital loss of approximately $6 million. The partnership allocated the capital loss to its members at the end of the year pursuant to subsection 96(1). The partnership then renovated and operated the property.

The minister reassessed the members of the partnership and denied the capital loss realized on the writedown of the property pursuant to GAAR.

MacKay conceded the existence of a tax benefit and advanced no defence in respect of abusive tax avoidance. Consequently, Campbell J only considered whether an avoidance transaction existed.

In respect of this determination, Campbell J rejected the minister’s position that each individual transaction must be considered independently:

\(^{60}\) Ibid., at paragraph 48.

\(^{61}\) Supra note 23.
I agree with the Respondent that subsection 245(3) requires the Court to determine the purpose of each transaction within a series to ascertain if the non-tax purpose was primary. If the non-tax purpose was primary for each transaction in the series, the GAAR cannot be applied to deny the tax benefit. However, I do not agree that every transaction must be assessed independently without regard to the overall purpose of the series. To do so would clearly frustrate the purpose of subsection 245(3). As paragraph 245(3)(b) explicitly considers that a series of transactions may result in a tax benefit, it is appropriate for this Court to consider the overall purpose of the series and it would be inappropriate to consider each transaction in a series in isolation from the overall purpose.62

Furthermore:

Determining the driving forces for undertaking a particular transaction within a series cannot be undertaken in isolation from the overall purpose of the series. While the overall purpose of the series will not be determinant, it remains one of the pertinent facts which this Court must consider in a determination of avoidance because the Court must determine if the overall purpose was the primary purpose of each transaction. Therefore while a transaction may initially present itself as one which the taxpayer has undertaken for the sole purpose of obtaining a tax benefit, its primary purpose may still be a non-tax purpose when assessed with reference to the overall series where the facts support that the dominant aim is to achieve a commercially reasonable deal in a tax effective manner.63

Campbell J then went on to summarize the Tax Court’s application of the avoidance transaction part of GAAR post-Canada Trustco. In doing so, she attempted to reconcile the differing decisions in Evans and Desmarais (discussed below):

Both Evans and Desmarais involved surplus stripping; however, the facts in each case were considerably different. Although the conclusions reached in Evans and Desmarais differed, both decisions had regard to the overall purpose of the series of transactions. In Evans, the “method” and the aim of each transaction was consistent with the overall purpose. In Desmarais, Justice Archambault looked at each transaction individually but also compared the purpose of each individual transaction to the overall purpose. The “method” chosen in Desmarais by the taxpayer was not consistent with the overall purpose of putting all the shares in one basket and, therefore, the purpose of that transaction was not primarily for non-tax reasons. The fact that there was an inconsistency between the overall commercial purpose and the purpose of the individual transaction is extremely relevant in explaining the different conclusions in the two decisions. As the subsection 245(3) determination is a factual inquiry, the different conclusions are based on the individual facts of each case, although both applied the Canada Trustco test.64

62 Ibid., at paragraph 61.
63 Ibid., at paragraph 63.
64 Ibid., at paragraph 69 (emphasis added).
In respect of the facts in *MacKay*, Campbell J concluded:

An objective assessment of all of the driving forces of the transactions as a whole, and each individual transaction, supports my conclusion that obtaining tax losses was not the primary purpose of any of the transactions. Each transaction was legally enforceable; valid and binding; and was neither vacuous nor artificial. The Appellant’s commercial purpose of acquiring the Shopping Centre to carry out its Business Plan was the primary purpose of each transaction. Thus, none of the transactions were avoidance transactions within the meaning of subsection 245(3).65

The minister’s appeal of this decision has been set down for hearing by the Federal Court of Appeal on February 7, 2008.

In light of the foregoing, taxpayers should be entitled to the tax benefits of their tax plans provided that the primary overall purpose of the series of transactions is not tax-motivated, and that each of the individual transactions in the series is consistent with this overall non-tax purpose. As the Tax Court held in *MacKay*, *Evans*, *MIL Investments*, and *McMullen*, employing tax-effective strategies to achieve a non-tax purpose does not in itself constitute an avoidance transaction.66

**Desmarais**67

In *Desmarais*, the appellant incorporated a holding company (“6311”) of which he was the sole shareholder. He then rolled in all of his shares in a company (“Gestion”) that he controlled with his brother in exchange for additional shares of 6311. The appellant (Desmarais) and the holding company then jointly elected under section 85, such that the agreed-upon basis of the 6311 shares was equivalent to the basis in the Gestion shares.

Desmarais then rolled into 6311 two-thirds (41) of the 60 shares that he owned in another company (“Comsercom”), which he did not control either individually or as part of a related group, in exchange for additional shares of 6311. This rollover was done at fair market value such that Desmarais realized a capital gain. Desmarais sheltered this capital gain using part of the capital gains deduction available under section 110.6. Because 6311 owned less than 10 percent of the Comsercom shares, section 84.1 did not apply to grind the PUC on the shares that Desmarais held in the holding company. The PUC on Desmarais’s 6311 shares was increased by the fair

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65 Ibid., at paragraph 124.

66 This principle is consistent with the pre-Canada Trustco decision of the Tax Court in *Geransky*, supra note 1, wherein, at paragraphs 36 and 37, the court determined that there was no avoidance transaction even though the appellant had undertaken certain transactions to achieve a tax-effective result. At paragraph 28, the court held, “What we have here is a purely commercial transaction conceived by business persons without any particular tax motivation and carried out with the assistance of tax professionals in a manner that is designed to achieve that result with the least unfavourable tax consequences.”

67 Supra note 24.
market value of the 41 Comsercom shares transferred to 6311. When 6311 subsequently redeemed some of its shares held by Desmarais, there was no deemed dividend because the consideration received by Desmarais for the shares did not exceed the PUC in respect of those shares.

As a result of the rollover and subsequent transactions, Desmarais effectively converted what would otherwise have been taxable dividends into a tax-sheltered capital gain followed by a tax-free redemption of shares. The minister reassessed Desmarais and included the redemption proceeds in his income as taxable dividends.

In determining whether the taxpayer engaged in an avoidance transaction, Archambault J rejected both Desmarais’s and the minister’s arguments. Desmarais argued that the primary overall purpose of the series of transactions was merely “the reorganization of his patrimony, in particular by separating his share in the liquid assets of Gestion.”68 The minister accepted Desmarais’s overall non-tax purpose but claimed that

Mr. Desmarais went further than merely transferring his share of the liquid assets of Gestion to 6311. He succeeded in stripping Gestion of $123,000 without paying any tax, and the redemption of the 123,000 class D shares [of 6311] was not essential to attain his primary purpose.69

Choosing his own path in the avoidance transaction analysis, Archambault J determined that

the transaction in which Mr. Desmarais transferred only 41 of his shares of Comsercom, amounting to 9.78% of this company’s shares, cannot be considered to have been concluded primarily for bona fide purposes, other than non-tax purposes.70

Notwithstanding Campbell J’s explanation in MacKay, Archambault J’s finding with respect to an avoidance transaction is difficult to reconcile with the other post-Canada Trustco decisions discussed above. As in those other cases, in Desmarais, the appellant’s overall purpose was not tax-motivated. Desmarais merely sought to achieve his non-tax purpose in a tax-efficient manner by avoiding the application of the specific anti-avoidance rule in section 84.1.

Copthorne

In Copthorne, Campbell J determined that the sale of shares by Copthorne I to Big City (the 1993 share sale) was an avoidance transaction, notwithstanding the appellant’s position that the primary purpose of this transaction and the subsequent amalgamation of Copthorne I and VHHC Holdings was the reorganization of the Li family’s corporate holdings. In this respect, Campbell J held:

68 Ibid., at paragraph 21.
69 Ibid., at paragraph 22.
70 Ibid., at paragraph 23.
While the overall purpose of the First Series of Transactions, including the First Amalgamation, could be viewed as having a legitimate non-tax purpose, the 1993 Share Sale was not an integral component to achieving the commercial purpose of simplifying the Li family corporate holdings.\footnote{71}

Campbell J’s reasoning in Copthorne appears to depart from the previous GAAR decisions of the Tax Court, including her own in MacKay. In Evans, tax-efficient means to achieve an overall non-tax purpose were acceptable. As discussed above, in MacKay, Campbell J explained that differing conclusions were reached in Desmarais and Evans because in Evans, all of the transactions undertaken by the taxpayer were consistent with the stated overall non-tax purposes, whereas in Desmarais this was not the case. Yet in Copthorne, the avoidance transaction test was interpreted more broadly to include a transaction that was not integral to achieving the overall non-tax purpose of the series.

Campbell J’s decision in Copthorne, if correct, may be regarded as an expansion of the test for avoidance transactions, which would weaken the principles of certainty, consistency, and predictability as espoused by the Supreme Court in Canada Trustco and the subsequent Tax Court decisions in Evans and MacKay. This idea was recognized by Campbell J in MacKay when she stated:

> The Supreme Court was insistent in Canada Trustco that Parliament intended to preserve predictability, certainty and fairness in Canadian tax law. This cannot be achieved if every business deal or arrangement undertaken with the benefit of tax advice is subject to the abuse analysis in section 245. The inquiry to determine whether a transaction is an avoidance transaction is not a results-based test.\footnote{72}

Assuming that the Tax Court’s reasoning in Evans and MacKay carries more weight in its future GAAR decisions than the reasoning in Copthorne (and assuming that Copthorne is correct and upheld on appeal), tax practitioners may take some comfort from the earlier decisions, which have considerably narrowed the avoidance transaction test. On the basis of Evans and MacKay, it may be said that tax-efficient strategies and tactics to achieve primary non-tax goals will likely not be subject to GAAR attacks. Furthermore, MacKay outlines the path to take in order to distinguish an arrangement from Desmarais, and perhaps Copthorne. Where the transactions undertaken by the taxpayer do not directly contradict the overall non-tax purpose of the plan, the taxpayer should be entitled to enjoy the tax benefits of the plan.

Abusive Tax Avoidance

On the determination of whether or not abusive tax avoidance exists, the Supreme Court in Canada Trustco stated:

\footnote{71} Copthorne, supra note 27, at paragraph 54.
\footnote{72} MacKay, supra note 23, at paragraph 75.
The heart of the analysis under s. 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case. The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The next task is to determine whether the transaction falls within or frustrates that purpose. The overall inquiry thus involves a mixed question of fact and law. The textual, contextual and purposive interpretation of specific provisions of the Income Tax Act is essentially a question of law but the application of these provisions to the facts of a case is necessarily fact-intensive.

This analysis will lead to a finding of abusive tax avoidance when a taxpayer relies on specific provisions of the Income Tax Act in order to achieve an outcome that those provisions seek to prevent. As well, abusive tax avoidance will occur when a transaction defeats the underlying rationale of the provisions that are relied upon. An abuse may also result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions. By contrast, abuse is not established where it is reasonable to conclude that an avoidance transaction under s. 245(3) was within the object, spirit or purpose of the provisions that confer the tax benefit.

The Supreme Court also determined that the minister bears the burden or onus of establishing abusive tax avoidance. In Placer Dome Canada Ltd. v. Minister of Finance (Ontario), the Supreme Court noted that this burden or onus is properly the minister’s where the taxpayer has already complied with the letter of the law, because

\[\text{[it] would be both impractical and unduly onerous to require a taxpayer whose transaction falls within the four corners of a tax provision to also disprove that he or she has violated the object, spirit or purpose of the provision.}\]

In the Tax Court cases discussed above in which the taxpayer has been successful, the minister has either failed to establish a tax benefit (Univar) or failed to establish an avoidance transaction (Evans, Overs, Mill Investments, McMullen, and MacKay). Thus, in none of these cases has the court’s decision hinged on the abusive tax avoidance part of the GAAR test. Nevertheless, these decisions, as well as those in which the taxpayer has not been successful, may be mined for important principles relative to the abusive tax avoidance.

**Evans**

In Evans, Bowman CJ addressed the issue of abusive tax avoidance, even though he was not required to do so (having found in favour of the appellant on the avoidance transaction part of the test). As noted above, he found that the appellant had used

73 Canada Trustco, supra note 2, at paragraphs 44-45.
74 Ibid., at paragraphs 52 and 63-65.
75 2006 DTC 6532, at paragraph 28 (SCC).
the relevant provisions “for the very purpose for which they are in the Act,” and observed, “I do not think that it can be said that there is an abuse of the provisions of the Act where each section operates exactly the way it is supposed to.”

**McMullen**

In *McMullen*, Lamarre J followed the lead of Bowman CJ in *Evans* on the question of abusive tax avoidance:

In light of those principles, I do not find that the transactions herein defeat or frustrate the object, purpose or spirit of any of the provisions of the Act referred to above. Those transactions do not lack economic substance. They were real and had legal effect. They were not shams. There was a genuine change in the legal and economic relations between the two former shareholders in DEL. As stated in *Evans*, “[t]o treat the transactions as abusive so that their results can be recharacterized would not preserve but rather would destroy certainty, predictability and fairness and would frustrate Parliament’s intention that taxpayers ‘take full advantage of the provisions of the Act that confer tax benefits’” (paragraph 35(c)).

**Desmarais**

In *Desmarais*, Archambault J ultimately determined that the appellant engaged in abusive tax avoidance, on the following basis:

- “it is possible that Comsercom will not be able for several years to distribute substantial dividends to its shareholders”; and
- “who is to say that the surpluses of Comsercom will necessarily be distributed to its shareholders?”

In conclusion, Archambault J stated:

[The fact that the funds from Gestion received as dividends by 6311 were used to redeem the class D shares was an abusive circumvention of the rule in section 84.1 and, consequently, all the conditions for the application of section 245 were present.]

Archambault J’s reasoning in support of his conclusion that transactions undertaken by Desmarais frustrated a specific provision of the Act is surprisingly speculative, and is more applicable to a consideration of whether the appellant enjoyed a tax benefit than whether he engaged in abusive tax avoidance. Archambault J provided no analysis as to how the object, spirit, and purpose of section 84.1 was frustrated. Even assuming that his speculation as to the future payment of dividends proved to be accurate,

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76 *Evans*, supra note 18, at paragraphs 28 and 29.
77 *McMullen*, supra note 22, at paragraph 54.
78 *Desmarais*, supra note 24, at paragraph 39.
79 Ibid., at paragraph 40.
80 Ibid., at paragraph 41.
how can the object, spirit, or purpose of a provision with a 10 percent bright line test be frustrated if the test is not met? If Parliament did not intend for taxpayers to rely on this bright line test, the remedy is for Parliament to change the test.

To reiterate the Supreme Court’s statement in Canada Trustco, applied by the Tax Court in Evans, Overs and McMullen,

[w]here Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.

Section 84.1 specifies precisely what conditions must be satisfied to avoid its application. In our view, Desmarais contradicts the principles outlined in Canada Trustco and ignores the decision in Evans. As a result, it muddies the waters for tax planners seeking to avoid running aground on GAAR.

**Lipson**

In Lipson, the appellant, Earl Lipson, sold shares in a family investment company to his spouse, Jordanna, who purchased the shares with the proceeds from a bank loan. Earl used the funds he received from Jordanna to purchase a personal residence. The next day, Earl and Jordanna took out another loan from the bank and used the proceeds to pay off Jordanna’s original debt. The bank used the house purchased by Earl as security on this second loan.

Earl and Jordanna chose not to elect out of the spousal rollover provisions in subsection 73(1), such that Earl was not subject to a capital gain on the disposition of his shares. Furthermore, pursuant to the operation of the spousal attribution rules in subsection 74.1(1), all dividends received on the shares were attributed to Earl, as was the interest expense incurred on the second loan.

As the transaction was structured, the interest on the first loan was deductible pursuant to paragraph 20(1)(c), and the interest on the second loan was deductible pursuant to subsection 20(3).

Unfortunately, Earl admitted the existence of avoidance transactions at trial. Given the Tax Court’s interpretation of what constitutes an avoidance transaction in Evans and Overs, as well as the subsequent cases of MIL Investments, McMullen, and MacKay, it seems that a strong argument could have been made that Earl did not in fact engage in any avoidance transactions. The overall purpose of the series of transactions was the sale of Earl’s shares to Jordanna, a bona fide non-tax purpose.

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81 Supra note 18, at paragraphs 28-29.
82 Supra note 19, at paragraph 18.
83 Supra note 22, at paragraph 53.
84 Canada Trustco, supra note 2, at paragraph 11.
85 Supra note 25.
86 Ibid., at paragraph 3.
None of the individual transactions in the series were inconsistent with this overall non-tax purpose.

At the abusive tax avoidance stage of GAAR, Bowman CJ seemed intent on revisiting his decision in Singleton,\(^87\) which was overturned by the Federal Court of Appeal.\(^88\) The Federal Court of Appeal’s decision was affirmed by the Supreme Court.\(^89\)

At the Tax Court in Singleton, Bowman J (as he then was) had espoused the “true economic purpose” doctrine, referring to

the inescapable factual determination that the true economic purpose for which the borrowed money was used was the purchase of a house, not the enhancement of the firm’s income earning potential by a contribution of capital.\(^90\)

In allowing the taxpayer’s appeal in Singleton, the Federal Court of Appeal stated:

In the case at bar, the direct use of the borrowed funds was to refinance the appellant’s capital account at the firm. Treating the borrowed funds as used for financing the purchase of the home ignores what the appellant actually did, i.e. used the borrowed funds to replace the funds required for his capital account at the firm. As stated by Dickson, C.J.C. in Bronfman Trust, the Court cannot ignore the direct use to which the appellant put the borrowed money.\(^91\)

In dismissing the minister’s appeal in Singleton, the Supreme Court rejected the Tax Court’s search for the “true economic purpose” and determined that Bowman J had applied the “wrong legal test.”\(^92\)

Nevertheless, in Lipson, Bowman CJ chose to apply the same test, finding that

[t]he purpose of the scheme was to create the impression that money was borrowed to repay money used to buy shares when in reality it was borrowed to buy a house and to allow Earl to deduct the interest on borrowed money used to buy the house.\(^93\)

Upon determining the “true economic purpose” of the impugned transactions, Bowman CJ found that Earl Lipson had engaged in abusive tax avoidance:

The purpose of the series of transactions was to make the interest deductible that would not be deductible if the money was simply used to buy the house.\(^94\)

Thus, Bowman CJ concluded, paragraph 20(1)(c) had been misused.

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87 Singleton v. The Queen, [1996] 3 CTC 2873 (TCC).
88 Singleton v. The Queen, [1999] 3 CTC 446 (FCA).
90 Singleton, supra note 87, at 2878-79.
91 Singleton, supra note 88, at paragraph 19.
92 Singleton, supra note 89, at paragraph 22.
93 Lipson, supra note 25, at paragraph 9.
94 Ibid., at paragraph 16.
Having rejected the commercial purpose of the initial loan received by Jordanna Lipson, Bowman CJ found that the refinancing had no commercial purpose:

The initial and supposedly commercial use was never intended to continue into the refinancing. That is evidenced by (a) the nullification for tax purposes of the effect of the sale of the shares by Earl to Jordanna coupled with (b) the immediate and inevitable flow of the borrowed money from the bank through the hands of Jordanna and Earl to its ultimate destination in the hands of the vendor of the home.95

In so finding, Bowman CJ ignored the economics of the deal in favour of the fiction created by provisions of the Act. While the tax consequences in respect of the shares sold by Earl (the taxpayer) to his spouse remained with Earl, the economic consequences of the ownership of the shares were in fact transferred to his spouse. The fact that Earl used the funds he received on the sale of his shares to acquire a house did not change the economics of the deal.

Notwithstanding the foregoing, having looked behind the transactions entered into by the appellant and his spouse to determine the “true economic purpose,” Bowman CJ concluded that various provisions of the Act had been misused:

I think that the series of transactions involved here resulted in a misuse of the provisions of the ITA, specifically paragraph 20(1)(c) and subsection 20(3). To the extent that subsection 73(1) and section 74.1 are used to achieve that misuse and to execute the scheme as a whole, they too are being misused. Not one of the purposes of the provisions that I referred to above is being fulfilled by this series of transactions. The overall purpose as well as the use to which each individual provision was put was to make interest on money used to buy a personal residence deductible.96

Given Bowman CJ’s determination of abusive tax avoidance, the appellant’s decision not to challenge the minister’s tax-avoidance argument at the avoidance transaction stage of the GAAR test was fatal. It would have been difficult for the court to distinguish the principles espoused in Evans and Overs in determining what constitutes an avoidance transaction. Furthermore, in Evans, Bowman CJ recognized that the court may not recharacterize an impugned transaction in an effort to demonstrate the existence of an avoidance transaction.97

In particular, the facts in Overs and Lipson are so similar that disparate results would have been difficult to reconcile. In both cases,

- the appellant sold shares in a closely held corporation to his spouse;
- the spouse borrowed money to buy the shares;
- the proceeds from the sale of the shares were not subject to tax pursuant to section 73;

95 Ibid., at paragraph 27.
96 Ibid., at paragraph 23.
97 See the quotation from Evans reproduced in the text above at note 48.
the spouse’s interest expense deductions and dividend receipts were attributable back to the appellant; and

- the appellant used the funds from the sale of the shares for personal purposes—in *Overs*, to pay off a shareholder loan, and in *Lipson*, to buy a house.

Recently, the Federal Court of Appeal affirmed the Tax Court’s decision in *Lipson* and its finding of abusive tax avoidance. The Court of Appeal determined that “Bowman C.J. was entitled to consider the transactions as a whole and their overall purpose in the conduct of his misuse and abuse analysis and to give this factor the weight that he did.”

Citing the Supreme Court’s decisions in *Canada Trustco* and *Kaulius*, the Court of Appeal deferred to the Tax Court’s finding in respect of abusive tax avoidance.

Earl Lipson has applied for leave to appeal to the Supreme Court of Canada, which has been granted; the court has set April 23, 2008 as the hearing date.

*CECO*  

In *CECO*, the appellant sought to dispose of its business assets to an arm’s-length purchaser. To achieve this objective, *CECO* transferred the assets into a partnership, pursuant to subsection 97(2), in exchange for a partnership interest and “other consideration.” The agreed-upon elected amount for purposes of subsection 97(2) was the “other consideration” received by *CECO* on the rollover into the partnership. The partnership interest received by *CECO* was valued at approximately $18 million.

Subsequently, the partnership subscribed for shares in *CECO*’s sister company, for which it paid approximately $18 million. The sister company distributed these proceeds to its parent company, which then flowed them up to *CECO*’s ultimate principals. Because the subscription proceeds were not received by *CECO* as consideration for the business assets, *CECO* was not required to recognize such consideration in its income.

The minister issued a GAAR reassessment in respect of the tax-free rollover. At the Tax Court, Bonner J upheld the reassessment, finding that there had been a “patent abuse of ss. 97(2).”

Several important facts assisted Bonner J in finding that *CECO* had engaged in abusive tax avoidance:

1. The sister company shares acquired by the partnership were worth only \( \frac{1}{10} \) of what the partnership paid.
2. The partnership was not entitled to enjoy any benefits of its ownership of the sister company shares.¹⁰⁴
3. The cost to the partnership of the sister company shares was approximately the same as CECO’s partnership interest.¹⁰⁵
4. The evolution of the transactions undertaken by CECO was exposed (owing to the lack of privilege attached to any of CECO’s documents and correspondence), thus evidencing the underlying tax motivation.¹⁰⁶
5. CECO’s own witness confirmed that the impugned transactions were exclusively tax-motivated.¹⁰⁷

While the outcome in this case is not surprising, given the bad facts, bad evidence, and discoverable tax-planning documents, CECO is useful in illustrating the importance of firming up a tax plan with a defensible overall non-tax purpose.

**Copthorne**

Given Campbell J’s finding in *Copthorne* in respect of the existence of a tax benefit and an avoidance transaction, her finding pertaining to abusive tax avoidance is not particularly surprising. After analyzing subsections 89(1), 87(3), and 84(3), Campbell J concluded:

At first glance in this appeal, it is not immediately obvious that any of the transactions in this appeal constitute abusive tax avoidance. The provisions of the Act appear to have operated precisely as they were intended to, producing the results that would be expected. . . . However, when the Redemption is viewed together with the 1993 Share Sale of VHHC Holdings to Big City, the abusive element becomes apparent. When VHHC Investments is later amalgamated with Copthorne II, the underlying principles respecting the calculation of PUC are offended because approximately $67 million of PUC is essentially double counted in the PUC of the newly amalgamated corporation. It is this double counting that circumvents the proper application of the relevant provisions in a manner that frustrates and defeats the object, spirit and purpose of those provisions, which individually, together and when read in conjunction with other provisions in the Act, are meant to operate to prevent the artificial increase of PUC on amalgamation and its subsequent return to shareholders on a tax free basis. Of the total PUC of $164,138,025 associated with Class D Preference shares, $96,736,845 belonged to VHHC Investments and $67,401,280 belonged to Copthorne II. However, the $67,401,279 can be traced back to the investment made by VHHC Investments in the common shares of VHHC Holdings, a lower tiered subsidiary. . . . This is the origin of the double counting of $67,401,279 of PUC and the aggregate of $67,401,279 and $96,736,845 results in this artificial increase. Instead $142,035,895 was distributed as a tax-free return of capital when only $96,736,845 of PUC was actually ever available for

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¹⁰⁴ Ibid., at paragraphs 5 and 42.
¹⁰⁵ Ibid., at paragraph 79.
¹⁰⁶ Ibid., at paragraph 28.
¹⁰⁷ Ibid., at paragraphs 48-52 and 70.
distribution. Consequently, the overall result that the relevant provisions were meant to address has been circumvented. In doing so, the purpose and underlying rationale of these statutory provisions (as well as corporate principles) have been frustrated and their object, spirit and purpose defeated. The resulting artificial preservation and inflation in PUC allowed the stripping of surplus without appropriate withholding tax. When the many transactions here are distilled down to the essential core, it is clearly an abuse of the Act to which section 245 should apply.108

Even though the provisions relied upon by the appellant in Copthorne appeared to work exactly as they were supposed to (as was the case in Evans and Overs), Campbell J ultimately found that the PUC provisions of the Act were in fact circumvented or frustrated. The decision in Copthorne further underscores the importance of the avoidance transaction part of the GAAR test, where, with the right tax planning and implementation, taxpayers may enjoy some measure of certainty, consistency, fairness, and predictability.

Conclusion
Following the Supreme Court’s first GAAR decisions in Canada Trustco and Kaulius, it was expected that taxpayers and their advisers would face some level of uncertainty as to the effectiveness of their tax plans. Given the disparate decisions of the Tax Court in Evans and Desmarais, Overs and Lipson, and MacKay and Copthorne, this expectation has materialized to some extent. That said, the post-Canada Trustco decisions of the Tax Court have exhibited a level of certainty, consistency, and predictability, while also revealing important principles that may assist tax practitioners in developing, documenting, and implementing their tax plans.

As noted in Univar, where the minister attempts to establish a tax benefit by referring to an alternative arrangement, there will be a tax benefit only if the alternative arrangement would have achieved all of the taxpayer’s objectives in entering into the actual transactions. In these cases, tax practitioners should document all of the various bona fide objectives and reasons for the transactions, in order to establish the basis for the transactions, eliminate potential alternative arrangement arguments, and fortify any avoidance transaction defences.

In terms of whether an avoidance transaction exists, Evans, Overs, MIL Investments, McMullen, MacKay, and even Desmarais reveal an unexpected level of consistency and predictability. Notwithstanding Copthorne, there should be no avoidance transaction provided that the tax plan has a primary, bona fide, non-tax purpose and the individual transactions carried out under the plan are not inconsistent with that purpose. To benefit from the foregoing Tax Court interpretations of what does and does not constitute an avoidance transaction, tax practitioners should do the following:109

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108 Copthorne, supra note 27, at paragraph 74.

1. Solidify the commercial, business, family, investment, or other non-tax purpose of the plan.
2. Structure the plan so that each individual transaction is consistent with the overall non-tax purpose.
3. Ensure that the paperwork documenting the plan is consistent with the plan and supports its overall non-tax purpose.
4. Advise the plan participants of what they need to do in order to comply with the plan, and ensure that they act accordingly.

Provided that the Tax Court consistently continues to interpret the avoidance transaction part of GAAR in the manner outlined above, that tax practitioners properly structure and document their tax plans, and that plan participants act in accordance with those plans, we may yet see an unprecedented level of certainty, consistency, predictability, and fairness in the application of GAAR.

**Addendum**

On March 19, 2008, shortly before this article went to press, the Federal Court of Appeal rendered its decision in *MacKay v. The Queen* (2008 FCA 105). In allowing the minister’s appeal, the court appears to have expanded considerably the scope and application of the avoidance transaction part of GAAR. At paragraph 21 of the decision, the court stated:

> I must respectfully disagree with Justice Campbell’s interpretation of subsection 245(3). In my view, her interpretation is incorrect because it is not consistent with the language or the purpose of subsection 245(3), particularly paragraph 245(3)(b). As I read paragraph 245(3)(b), it requires a determination of the primary purpose of any transaction (or transactions) within a series of transactions that would result in a tax benefit if the GAAR does not apply. It follows that a subset of transactions within a series of transactions is an avoidance transaction unless the subset of transactions may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit. In my view, the conclusion that a series of transactions was undertaken primarily for *bona fide* non-tax purposes does not preclude a finding that the primary purpose of one or more steps within the series was to obtain a tax benefit.

A more detailed analysis of this decision is not feasible here, but practitioners should take the court’s ruling into consideration in the development, implementation, and defence of their tax plans.

As we have noted, the Supreme Court of Canada is expected to hear the appeal of the *Lipson* decision in April 2008; however, what constitutes an avoidance transaction is not at issue in that case. It is therefore hoped that the respondents in *MacKay* will seek leave to appeal the decision of the Federal Court of Appeal, and thus provide the Supreme Court with the opportunity to clarify the avoidance transaction part of the GAAR test.