TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

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PIERCING THE CORPORATE VEIL IN THE FAMILY LAW CONTEXT

Tax planners rely on the principle that shareholders and corporations are separate legal entities, and that generally one cannot be responsible for the debts or obligations of the other. However, recent cases remind us that that this is only a general rule, and that in the right (or, more accurately, the egregiously wrong) circumstances, corporate assets may be attached to satisfy an obligation of a shareholder.

The doctrine of piercing the corporate veil is usually considered when an aggrieved party tries to impose liability for corporate misconduct on a shareholder. In the family law context, however, a court may order that corporate assets be used to satisfy the support obligations of a delinquent shareholder. A recent Ontario case suggests that there are limits on how aggressive family estate planning can be.

In *Wildman v. Wildman* (2006 CanLII 33540 (Ont. CA)), the Ontario Court of Appeal confirmed the decision of the trial judge, who had ordered that all amounts owing by the delinquent spouse be secured and enforceable not only against him but also against the various companies through which he operated his businesses. The trial judge ordered the delinquent spouse to pay more than $800,000 for spousal and child support, costs, and interest, of which "the appellant [challenged] not one penny." However, the delinquent spouse challenged the enforcement mechanisms imposed, on the basis that the separate legal personality of the shareholder and the corporation had been disregarded.

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The Ontario Court of Appeal said that the principle of separate legal personality was important, but not absolute; the principle should be disregarded where the corporation "is completely dominated and controlled and [is] being used as a shield for fraudulent or improper conduct." The court emphasized that the corporation need not have been created with an improper purpose in mind; it is sufficient that the corporation was used for an improper purpose.

The court, citing *Arsenault v. Arsenault* ([1998] OJ no. 1423), confirmed that three circumstances must be present before it will look behind the corporate veil:

1) The individual must exercise complete control of the finances, policy, and business practices of the company.
2) The individual must have used that control to commit a fraud or wrong that would unjustly deprive a claimant of his or her rights.
3) The misconduct must be the reason for the complainant's injury or loss.

Observing in passing that there was a strong public policy argument to be made for a review of closely held corporations in the context of support, especially with the connection between non-payment of support and child poverty, the court concluded that

> [i]n the end, although a business person is entitled to create corporate structures and relationships for valid business, tax and other reasons, the law must be vigilant to ensure that permissible corporate arrangements do not work an injustice in the realm of family law. In appropriate cases, piercing the corporate veil of one spouse's business enterprises may be an essential mechanism for ensuring that the other spouse and children of the marriage receive the financial support to which, by law, they are entitled.

No doubt this conclusion will be tested on estate plans in cases where some family members feel that they have received less than their legal entitlement. More disclosure and better communication among the business owners, the planners, and the beneficiaries and family members may be the way to avoid litigation.

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(Editor's note: See Nisker *(2006 TCC 651) for a case in which the Tax Court pierced the corporate veil in holding that a shareholder of a corporation was carrying*

on the business of the corporation and was entitled to deduct damages awarded against him personally relating to a tort committed in the course of that business.)

Tax Evasion: Wilful Blindness Is No Defence

In a tax evasion case, the prosecution must prove beyond a reasonable doubt that the accused knowingly attempted to evade tax. A recent Ontario case, *Chahine-Badr* ((2006), 79 OR (3d) 671 (Ont. SCJ)), shows that while in theory there may be a distinction between actual knowledge and wilful blindness, in practice a taxpayer who is wilfully blind to the consequences of his actions—without actual knowledge of the tax consequences—may have sufficient knowledge to be convicted of tax evasion. The case is also a disturbing example of how a taxpayer's right to non-incrimination in a criminal proceeding may be illusory in the context of a prosecution for tax evasion.

Background

The CRA and the provincial ministries of revenue enjoy broad statutory powers to inspect and examine records and to compel a taxpayer to provide information and documents—all without prior judicial authorization. The taxpayer must accede to such requests: see subsections 231.1(1) and 231.2(1) of the Income Tax Act (ITA) and subsections 288(1) and 289(1) of the Excise Tax Act. In the course of the audit process, an assessor may uncover evidence suggesting that tax evasion has occurred. If so, at some stage in the process the assessor will refer the matter to the tax authority's special investigations branch. If sufficient evidence of an offence is discovered, criminal charges will generally be laid.

In such a case, it is important to determine just when the CRA's review ceased to be a compliance audit and became a criminal investigation: a taxpayer's rights under the Charter of Rights and Freedoms are engaged only when the criminal investigation begins. It is at this point that, among other consequences, the taxpayer is afforded the right to silence, and the tax authority is required to obtain a judicial warrant before examining any further documents (see *Jarvis* (2002 SCC 73)).

The Chahine-Badr Case

In *Chahine-Badr*, the taxpayer was the founder, sole shareholder, and president of a company that distributed batteries and small electronic goods at mall kiosks across Canada. Acting on an anonymous tip, the CRA conducted an audit under ITA subsections 231.1(1) and 231.2(1). At some point during the audit, the auditor referred the file to the CRA's investigations branch, which commenced a criminal investigation, obtained further records pursuant to search warrants obtained on the basis of the information revealed during the compliance audit, and eventually laid numerous counts of tax evasion against the taxpayer.

At trial, the taxpayer brought an application to exclude the books and records obtained during the audit on the grounds that the audit violated his rights under the Charter. The taxpayer argued that the CRA in effect conducted a warrantless search in that the compliance audit was in furtherance of a criminal investigation. The trial judge denied the application and admitted the books and records as evidence. The taxpayer was ultimately convicted, and he appealed the decision to the Superior Court of Justice.

The Appeal

Two issues were raised in the appeal: (1) whether the trial judge was correct in admitting the evidence from the compliance audit, and (2) whether the trial judge erred in finding the taxpayer guilty on the basis of his conclusion that "wilful blindness" was sufficient to support the charge of tax evasion.

On the first issue, the taxpayer argued that the trial judge erred in interpreting and applying the rules set out in *Jarvis*, and that the evidence should have been excluded under section 24(2) of the Charter. The Appeal Court reviewed the *Jarvis* tests for determining when the predominant purpose of an inquiry becomes the determination of penal liability:

1) Did the authorities have reasonable grounds to lay charges? Does it appear from the record that a decision to proceed with a criminal investigation could have been made?
2) Was the general conduct of the authorities such that it was consistent with the pursuit of a criminal investigation?
3) Did the auditor transfer his or her files and materials to the investigators?
4) Was the conduct of the auditor such that he or she was effectively acting as an agent for the investigators?
5) Does it appear that the investigators intended to use the auditor as their agent in the collection of evidence?
6) Is the evidence sought relevant to the taxpayer's liability generally? Or, as is the case with evidence of the taxpayer's mens rea, is the evidence relevant only to the taxpayer's penal liability?
7) Are there any other circumstances or factors that can lead the trial judge to the conclusion that the

compliance audit had in reality become a criminal investigation?

The court, citing *Jarvis*, noted several additional principles to be considered in a case of this kind: (1) neither a "mere suspicion" that an offence has occurred nor the "mere existence of reasonable and probable grounds that an offence may have occurred" is by itself sufficient to indicate that the predominant purpose of an inquiry is the determination of penal liability; (2) conducting parallel criminal investigations and administrative audits is not in itself sufficient; (3) however, such a predominant purpose could exist even if the Crown has not yet laid charges.

On the whole, the court found no error in the trial judge's approach, and agreed that he had correctly admitted the audit evidence because it had not been improperly obtained through the use of the CRA's audit powers. On this point, the court noted that the dual remedy regime available under tax statutes distinguishes tax cases from Criminal Code cases, where the accused's Charter rights are also in play. Tax authorities should be given every opportunity to first resolve non-compliance matters through the use of their regulatory powers; this possibility would be lost if the tax authorities were forced to pursue the criminal regime whenever reasonable grounds indicating that an offence might have been committed were identified.

On the second issue (whether the trial judge erred in finding the taxpayer guilty only on the basis of his "wilful blindness"), the taxpayer argued that the trial judge improperly relied on the concept of wilful blindness to conclude that the taxpayer had the mens rea necessary for him to be found guilty of tax evasion. Further, because the Crown had not specifically raised wilful blindness as a basis for liability in the charges, the taxpayer argued that he was not aware of the case he had to meet and that his defence was thereby prejudiced.

The court, citing *Harding* ((2001), 57 OR (3d) 333 (Ont. CA)), said that wilful blindness is inherent in the concept of knowledge and is not an alternative theory of culpability. It is equivalent to actual knowledge because the accused " 'knew or strongly suspected' that inquiry on his part respecting the consequences of his acts would fix him with the actual knowledge he wished to avoid." In the result, the court dismissed the appeal.

Chahine-Badr is an important case for any tax practitioner (whether or not a lawyer) advising a client who may have crossed the line between tax non-compliance and tax evasion. The case underlines that the standard for the mens rea element of the offence of criminal tax evasion may be lower than generally thought. This has consequences both for the taxpayer (who cannot escape conviction merely by pointing to a lack of actual knowledge) and for the tax adviser (who must rely on other tactics and strategies for mounting a proper defence). The case also illustrates why, in an evasion case, it is so important to consult a tax lawyer experienced in criminal defence strategies at the earliest possible stage in the CRA's compliance audit.

Chahine-Badr seems to confirm that in all but the most exceptional of cases the tax authorities will be allowed to use evidence obtained from compliance audits to support search warrants and other investigative techniques in furthering criminal investigations. Some additional discussion of the limits on the tax authorities' powers in this regard would have been helpful. The *Jarvis* principles are very difficult to apply at the time that a compliance audit is initiated. What should a taxpayer do if he or she is required to produce books and records when the possibility of criminal charges has not been expressly raised but may be in the background? It appears from these cases that an accused may be required, by virtue of the CRA's exercise of its civil audit powers, to provide conscripted evidence (evidence that is forced out of the accused) that will be available for use in a subsequent criminal investigation. As of this writing, an accused's Charter rights seem woefully unprotected in such an event.

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Trading in Publicly Listed Securities: Capital Gains Versus Ordinary Income

Individuals who buy and sell listed securities almost invariably report their gains as being capital in nature if their main business does not involve such transactions. Generally speaking, and subject to certain exceptions noted in *Interpretation Bulletin* IT-479R (February 29, 1984), the administrative practice of the CRA is to accept such filing positions. Problems rarely arise unless an individual reports losses from security trading as ordinary losses rather than as capital losses, as the taxpayer in *Hawa* (2007 DTC 28 (TCC)) did.

The most important test for determining whether a gain is on account of income or capital is the taxpayer's intention at the time of acquisition: if the taxpayer's primary or secondary intention was to sell the property for a profit, the gain is ordinary income. (Other tests are also used by the courts to assess the taxpayer's intention.)

Although this principle is commonly applied to real estate transactions, it is rarely applied to security trades. In *Hawa*, Bowman CJ speculated that this is probably because the CRA does not want to recognize trading losses as being on income account; nor does it want to bear the administrative burden of pursuing this line of assessment.

Mr. Hawa had 151 trades in one year, and he generally held the securities only for short periods. The court found that Mr. Hawa had carried on a business, and his losses were treated as having been on income account. This is good news for taxpayers who have incurred losses but bad news for those who have realized gains. Taxpayers in circumstances similar to Mr. Hawa's would, if audited, likely have such gains reassessed as ordinary income. Those taxpayers should review their trades in order to ascertain whether some might relate to securities that were originally acquired for long-term retention and, in fact, were not part of the frequent trades. Such securities should constitute capital property even if other securities are inventory. Other taxpayers should consider making the election under subsection 39(4) of the Income Tax Act, where appropriate.

The subsection 39(4) election provides certainty in characterizing certain gains as capital gains. The election applies only to dispositions of "Canadian securities" (as defined in subsection 39(6)). Furthermore, paragraph 39(5)(a) precludes a taxpayer (other than a mutual fund corporation or a mutual fund trust) from making this election if the taxpayer is "a trader or dealer in securities."

Bowman CJ pointed out that Mr. Hawa's activities were "a concerted commercial activity of buying and selling shares over an extended period of time" and as such could "more appropriately be described as the carrying on of a business in the ordinary sense of that word without resort to the concept of 'adventure in the nature of trade.'" In *Vancouver Art Metal Works Limited* (93 DTC 5116 (FCA)), the court held that the phrase "trader or dealer in securities" includes a person engaged in a business that is not an adventure in the nature of trade. As a consequence, taxpayers in circumstances similar to those in *Hawa* will not be entitled to make the subsection 39(4) election because their activities will be considered to have gone beyond an adventure in the nature of trade, a phrase that probably contemplates relatively infrequent or isolated transactions.

Taxpayers who are confident that their trading activities have not evolved beyond an adventure in the nature of trade into the real business of securities trading can consider making the subsection 39(4) election in connection with transactions in Canadian securities. They should take into account the possibility that gains realized in prior taxation years that are not yet statute-barred could be reassessed as ordinary income. In this regard, it should be noted that the subsection 39(4) election must be made in prescribed form in the tax return for the year of the gain and that regulation 600 does not permit it to be late-filed. Taxpayers should also remember that if the election is made, all future gains and losses on Canadian securities will be treated as capital.

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Limitation on the Waiver of Penalty and Interest

Subsection 220(3.1) of the Income Tax Act (ITA) gives the CRA the discretion to waive or cancel all or part of any penalty or interest payable under the ITA. The provision took effect on December 17, 1991; it originally applied to penalties and interest in respect of the 1985 and subsequent taxation years and permitted the CRA to exercise its discretion at any time. *Information Circular* 92-2 (March 18, 1992) sets out the guidelines that the CRA followed in applying the provision.

Unfortunately, as a result of an amendment in 2005 (SC 2005, c. 19, section 48(1), generally applicable after 2004), the CRA's discretion has been limited. A taxpayer must now request the waiver or cancellation of all or part of a penalty or interest payable in respect of a taxation year on or before the day that is 10 calendar years after the end of that taxation year. If the application is not made within that period, the CRA does not have the discretion to waive or cancel all or part of the penalty or interest. In the case of a partnership, the same limitation applies, but the time period for making the application is measured from the end of the particular fiscal period. The CRA has the discretion to waive or cancel all or part of the penalty or interest without an application within the 10 year-period. Section 281.1 of the Excise Tax Act (ETA) imposes a similar 10-calendar-year limitation on the CRA's discretion to waive or cancel interest or penalties.

The 2005 amendment limits the CRA's discretion to waive or cancel a penalty or interest in circumstances where a waiver or cancellation is appropriate or justified, two of which are described below.

As a result of the decision in *Markevich* ([2003] 1 SCR 94), the ITA was amended to provide rules regarding limitation periods for the collection of federal taxes. (See "Tax Collection Powers Limited—for Now?" *Tax for the Owner-Manager*, July 2003.) All federal tax debts outstanding on March 4, 2004 that were uncollectible because of *Markevich* became collectible for 10 more years. The CRA now has the authority to commence collection action for dormant tax debts (tax, interest, and penalties) owing in respect of any taxation year even though the CRA may not have taken any action to collect the debts for many years. In such cases, it would be appropriate for all or part of the interest and penalty to be waived or cancelled, but the CRA may not have the discretion to do so.

The same issue can arise with respect to voluntary disclosures and taxation years that are subject to unresolved tax litigation. For example, if an individual taxpayer makes a voluntary disclosure in 2007, the CRA will not have the discretion to waive interest or penalty for 1996 or prior taxation years.

In these circumstances, a taxpayer's only recourse may be an application for a remission order under the Financial Administration Act (RSC 1985, c. F-11, as amended). Subsection 220(3.1) of the ITA (and section 281.1 of the ETA) should be amended to eliminate the 10-year limitation on the CRA's power to waive or cancel penalties or interest payable.

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Resolving SR & ED Disputes with the CRA

The SR & ED claim-processing procedures that we discussed in the January 2007 issue of *Tax for the Owner-Manager* have changed significantly. Unfortunately, the CRA has provided very little information with respect to the changes, and therefore we are not yet in a position to provide definitive information on the revised process. However, we can say that the Taxation Centres now have significantly more responsibility with respect to initial screenings, requests for information, and the risk-assessment process. We hope that details about the role of the Taxation Centres will be forthcoming from the CRA.

Background

Notwithstanding the revised SR & ED claim-processing procedures, if a disagreement occurs with the CRA regarding a claim, it will generally happen during an audit rather than during the initial screening and risk-assessment process.

When there are disagreements during an audit, it is important for the claimant to clearly communicate its position to the CRA. At the same time, it is important for the claimant to work with the CRA's financial and technical reviewers to understand their position. According to the CRA's published policy (see, for example, "Guide to Conducting a Technical Review," January 14, 2000), reviewers have an obligation to communicate their concerns to the claimant or its representatives as early in the audit as possible (normally, as soon as the concern is identified). Notwithstanding that the claimant has an obligation to substantiate its claim, the reviewers also have a responsibility to provide a full explanation of, and support for, their position. For example, it is not enough for a technical reviewer to say, "This work was not undertaken for the purpose of achieving a technological advancement": the CRA must explain *why*, in its view, that is the case.

When a dispute occurs between the CRA and a taxpayer, it has been the CRA's long-standing position (whether in an SR & ED review or a routine tax audit) that the taxpayer has the right to discuss the issue with the auditor's manager. The CRA has taken this policy one step further in the SR & ED program and issued "Guidelines for Resolving Claimants' SR & ED Concerns," *Application Policy* SR & ED 2000-02R (www.cra-arc.gc.ca/taxcredit/sred/publications/ap2000-02r-e.html). It is hoped that the majority of audit issues can be resolved through clear communication between the claimant and the reviewers. However, in situations where an agreement with reviewers cannot be reached with respect to the eligibility of work or expenditures, the claimant has the right to talk to the CRA's SR & ED management. Claimants also have the right to talk to management if they are concerned that due process was not given. The reviewers must provide claimants with the manager's name and contact information. It is our understanding that the CRA's SR & ED management would prefer that claimants come forward early in the process when problems arise; the problems may become more difficult to resolve after the auditor has invested a good deal of time and effort before management's involvement.

The CRA's SR & ED management should give the claimant every opportunity to discuss its concerns and to provide whatever information the claimant considers useful. It is hoped that issues that get to the level of the reviewer's manager can be resolved between the manager and the claimant. If an agreement still cannot be reached at this stage, claimants have the right to talk to the manager's supervisor, who is the assistant director (AD), SR & ED, for the coordinating Tax Services Office (CTSO). It is the manager's responsibility to provide claimants with the AD's name and contact information. This step in the process is termed "requesting an administrative second review."

A phone call to the AD is generally the best way to initiate contact. The AD may be willing to start discussing the situation at that point without requiring a formal submission. However, the AD may wish to precisely follow the guidelines, which state, "In order to initiate an Administrative Second Review, the claimant must make their request in writing to the SR & ED Assistant Director. In their request, the claimant should explain why they want an Administrative Second Review and should provide relevant facts and documentation to support their case."

The guidelines further state:

> When conducting an Administrative Second Review, the Assistant Director will determine whether:
>
> - the SR & ED technical and financial reviews were consistent with the current SR & ED legislation, application policies, and guidance documents; and
> - the claimant was given due process. . . .
>
> Based on the Assistant Director's determination, there are two possible outcomes of the Administrative Second Review: *Decision Maintained* or *Decision Reconsidered*.
>
> *i. Decision Maintained*
>
> If the Administrative Second Review reveals that the SR & ED technical and/or financial review was consistent with the current SR & ED legislation, application policies and guidance documents, and that the claimant was given due process, then the technical and/or financial review will proceed in the usual manner. The claimant will be advised of this outcome in a letter from the Assistant Director.
>
> *ii. Decision Reconsidered*
>
> If the Administrative Second Review indicates that the SR & ED technical and/or financial review was not consistent with the current SR & ED legislation, application policies and guidance documents, and/or the claimant was not given due process, then further action will be taken to address the Assistant Director's findings. For example, if the claimant was not given a reasonable opportunity to provide additional information to support their claim then the opportunity to do so will be provided. The claimant will be informed of this outcome in a letter from the Assistant Director.

Since their release in 2000, the guidelines have often been referred to as the second technical review process. It should be noted that claimants are not automatically entitled to a second technical review; that decision lies with the AD.

Although the matter is not mentioned in the guidelines, the AD, of course, also reports to someone—the director of the AD's TSO.

To summarize, the AD will make a decision on how to bring the file to closure from the CRA's perspective. An agreement may or may not have been reached between the claimant and the CRA. Regardless, once the CRA is of the view that the review process is complete, it will issue a final letter detailing all adjustments to be made in the assessment or reassessment of the claim.

If there is still a disagreement and the claimant wishes to further pursue the case, the claimant can file a notice of objection (also referred to as the appeals process) to the Appeals Branch of the CRA. A notice of objection must be filed within 90 days (not three months) of the date of the notice of assessment or reassessment. It is interesting to note that in the 1990s a relatively large number of claims went to the appeals process. In 1999, when the program focused on the incentive nature of the SR & ED legislation, there was a marked decrease in the number of appeals in the subsequent years. It is our understanding that the number of appeals is increasing significantly, although we do not have the CRA statistics to support this observation.

The CRA's Appeals Branch provides an independent and objective review of the case to determine whether the CRA has correctly applied the legislation and given the claimant due process. The appeals process can be extremely lengthy. If the appeals process does not resolve the situation to the claimant's satisfaction, then, once Appeals has finalized its position and advised the claimant appropriately, the claimant has the right to go to the Tax Court.

It is important to be fully aware of taxpayers' rights in navigating through the claim-review process, the appeals process, and the Tax Court process. The claimant has the right to representation during the claim-review process, as it does in the Tax Court. It is CRA policy to work with the claimant's representatives throughout the claim-review process.

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GAAR: "Avoidance Transaction" Revisited

Following the decisions of the Supreme Court of Canada in *Canada Trustco* (2005 SCC 54) and *Mathew* (2005 SCC 55), the Tax Court of Canada has departed significantly from the approach previously adopted by the Federal Court of Appeal in *OSFC Holdings* (2001 FCA 260) regarding the determination of whether a transaction is an avoidance transaction under subsection 245(3) of the Income Tax Act. In *MacKay* (2007 TCC 94), the Tax Court once again had regard to the overall purpose of the series of transactions as a factor in determining, as a question of fact, the primary purpose of each individual transaction (see also *Evans* (2005 TCC 684)). Campbell J held that "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."

In *MacKay*, the appellants conceded that the series of transactions, which were substantially similar to those considered in *Mathew* and in *OSFC Holdings*, gave rise to a tax benefit under subsection 245(1) and that there was no need for the court to engage in a review of whether the transactions constituted a misuse or abuse for the purposes of the subsection 245(4) exception. The sole issue considered by the court was whether there was an avoidance transaction as contemplated by subsection 245(3).

In summary, the facts of *MacKay* were as follows. A bank owned a non-performing $16 million mortgage receivable from a shopping centre, against which foreclosure proceedings were commenced. The appellants, who were real estate developers, agreed to purchase the shopping centre from the bank for approximately $10 million. The bank formed a partnership with a newly created wholly owned subsidiary and transferred the mortgage and its interest in the foreclosure proceedings to the partnership in exchange for limited partnership units. Under subsection 18(13), the deduction of the loss on the transfer of the receivable was disallowed and added to the partnership's tax cost of the mortgage. The partnership acquired the shopping centre pursuant to an order that, inter alia, substituted the partnership as the petitioner in the foreclosure proceedings. The bank then effectively sold its partnership units to the appellants for $10 million, the agreed-upon purchase price of the shopping centre. At the end of its first fiscal year, the partnership wrote down the shopping centre to its fair market value and allocated the loss to the partners on the basis of their proportionate shares.

The minister applied GAAR to deny the appellants' losses claimed in respect of the writedown of the mortgage. The minister submitted that an independent review of the primary purpose of each transaction in the series showed that the creation of the partnership and the transfer of the mortgage receivable were avoidance transactions. Although the court found that on an objective assessment it was apparent that one of the purposes for undertaking each of the transactions was to obtain a tax benefit, it was not the primary purpose of any of the transactions, either together or individually. The court held that the primary purpose of each of the transactions was the acquisition of the shopping centre, having regard to the overall purpose of the series. In the court's view, to divorce the purpose of each individual transaction in the series from the overall purpose of the series would frustrate the purpose of subsection 245(3) and interfere with the commercial realities of the marketplace. Campbell J reasoned that such an approach would be contrary to the underlying premise of the test set out in *Canada Trustco*—namely, reasonableness and the ability of taxpayers to arrange their affairs to minimize tax.

Many practitioners may find this decision surprising in light of the decisions in *Mathew* and *OSFC Holdings*, which Campbell J was careful to distinguish on their facts. *MacKay* highlights the importance, post-*Canada Trustco*, of not simply conceding that a transaction that gives rise to a tax benefit is an avoidance transaction (see, for example, *Mathew*).

Campbell J's decision underlines the significance of the facts in determining objectively whether there is an avoidance transaction. The key facts in *MacKay* were as follows:

- The appellants struck a deal with the bank on the basis of a business plan to acquire the property, improve it, stabilize its leases, and sell it for a profit. The purchase price was agreed upon without regard to any tax considerations.
- The level of due diligence performed, the acquisition of a mortgage, and the use of a partnership to acquire the shopping centre were consistent with the appellants' previous real estate investments.
- There was nothing in the documentation that indicated that the purchase price was in any way affected by the availability of tax losses.

The subjective evidence of the witnesses and the activities of the appellants following the closing of the transaction were consistent with the stated commercial purpose (as set out in the business plan) of the acquisition of the shopping centre.

A comparison of the value of the commercial benefits, including the expected profit to be realized on the sale of the shopping centre, with the value of the tax benefits associated with its structuring did not reveal any significant disparity and supported a finding that the primary purpose was a non-tax purpose.

The Tax Court's approach to subsection 245(3) is clearly consistent with the Federal Court of Appeal's decision in *Canadian Pacific Ltd.* (2001 FCA 398). The effect of this decision should be to deny the application of GAAR in future cases where the series may reasonably be considered to have been undertaken primarily for bona fide purposes other than to obtain a tax benefit, albeit in a tax-efficient manner.

It is anticipated that the minister will appeal this decision; to date, however, no application has been made. One would expect that the Federal Court of Appeal will embrace an opportunity to shed further light on the important issue of "overall purpose."

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(Editor's note: For an additional comment on the issue raised in the MacKay *case, see "Practice Notes," below.)*

Practice Notes

Avoidance Transactions: Is the TCC Avoiding the Issue?

In order to sustain an assessment based on GAAR, the court must find that the taxpayer engaged in an "avoidance transaction" as defined in subsection 245(3)—that is, any transaction that, standing alone (paragraph (a)) or as part of a series of transactions (paragraph (b)), results in a tax benefit, unless the transaction may reasonably be regarded as having been undertaken primarily for bona fide purposes other than to obtain that tax benefit. As the jurisprudence on the scope of GAAR develops, it appears that the reach of paragraph 245(3)(b) may not be as broad as some of us thought it was.

The interpretation of the paragraph comes into focus when a tax benefit results from a series of transactions which, in an overall sense, is primarily designed to achieve a non-tax purpose, but which includes a step that is motivated primarily for tax reasons. If the purpose test is applied to the series as a whole, there is no avoidance transaction. However, if the test is applied only to the tax-motivated step taken in isolation, that step taints the series as a whole—or so many of us thought. Looking back at how the Tax Court has dealt with this issue over the past 18 months or so, one is tempted to say that the weight of the jurisprudence to date suggests that an overall commercial motive is sufficient to sanitize any individual step in a series that is otherwise primarily tax-motivated. Whether this turns out to be a correct reading of the subsection depends on how the Court of Appeal deals with the issue. The court's judgment in the appeal of *Lipson* (2006 TCC 148) has just been released (docket no. A-231-06), March 19, 2007) and can be read as somewhat supportive of an "overall" approach. (*Lipson* is discussed in more detail below.)

An important issue of statutory interpretation is at stake here. If subsection 245(3) is given a narrow reading in the manner suggested by a number of the TCC decisions, the scope of GAAR will be correspondingly narrowed. As a consequence, planning that otherwise would be tested on the "misuse or abuse" criterion under subsection 245(4) will be outside section 245 altogether for failure to meet the definition of "avoidance transaction." On the other hand, if "avoidance transaction" is construed broadly, most GAAR issues will be argued in the context of the "misuse or abuse" test. Paragraph 245(3)(b) refers to *any* transaction in the series that is not motivated primarily for non-tax reasons. At least prima facie, this seems to support the argument that in a series of transactions, each step is to be tested on its own as to purpose. The Supreme Court seemed to imply as much in *Canada Trustco* (2005 SCC 54), where it said that "[i]f at least one transaction in a series of transactions is an 'avoidance transaction,' the tax benefit that results from the series may be denied under the GAAR. This is apparent from the wording of s. 245(3)."

The Tax Court, though, has taken somewhat different approaches to this point. In *Univar* (2005 TCC 723), *Evans* (2005 TCC 684), *MIL Investments* (2006 TCC 460), and, most recently, *MacKay* (2007 TCC 94), the court seemed to say that if the end purpose of the series was primarily a non-tax one, the intervening steps could be regarded as the "how" of the implementation process, so that the "why" of the individual steps was subsumed under that commercial purpose. In *Canadian Pacific* (2001 FCA 398), the court refused to regard certain steps as representing severable transactions and held that there was in fact only one composite transaction undertaken for a commercial purpose. In *Geransky* (2001 DTC 243), *Loyens* (2003 TCC 214), and *McMullen* (2007 TCC 16), the court found a bona fide commercial purpose for the steps, and refused to find that the purpose of any individual step was different from that which drove the overall transaction.

The *MacKay* decision is the most recent example of this sort of approach in the Tax Court—but with a wrinkle. The court noted the comments of the Supreme Court cited above, but effectively minimized their importance by saying that the existence or otherwise of a tax motive was a question of fact to be determined from all the circumstances of the case. The court placed a great deal of importance on the purpose of the overall series of transactions and implicitly concluded that if that purpose was primarily a commercial one, it infused the purpose of the individual steps as well. (See the discussion of *MacKay* in "GAAR: 'Avoidance Transaction' Revisited," above.)

The Supreme Court in *Canada Trustco* emphasized that the inquiry into the purpose of a transaction is a factual one and that appellate courts should not interfere with findings of fact supported by the evidence, absent a palpable and overriding error. Accordingly, if the Tax Court bases its finding regarding purpose on appropriate evidence, that finding generally should be the end of the matter. However, there remains the question of when an appellate court might hold that notwithstanding findings based on appropriate evidence, the lower court has nonetheless made a "palpable error"—for example, to what extent the purpose of individual steps is to be evaluated in the context of the overall purpose of the series or in isolation from it.

The point is of more than academic interest to tax professionals. Pending clarification from the Court of Appeal, it is difficult to give appropriate advice to clients seeking guidance on when transactions with an overall commercial purpose may be structured in a tax-efficient manner without triggering GAAR. If individual steps can be motivated for tax reasons without tainting the series, fewer transactions will be categorized as "avoidance transactions" and GAAR will have a more restricted application than would otherwise be the case. On the basis of the jurisprudence to date, the question is very much an open one. Until the point is clarified, prudent advisers should be reluctant to concede that a step in a series is an avoidance transaction when there is a commercial purpose for the overall series.

Lipson v. The Queen: The Purpose of a Series

If the purpose of a step in a series is to be determined having regard to the purpose of the series taken as a whole, does it follow that if no single step in a series offends the purpose test, then the series itself is not abusive? Or, to put the question a different way, can a series of transactions taken as a whole result in a subsection 245(4) abuse if each step in the series can be justified as having been undertaken primarily for a non-tax purpose? The Court of Appeal's decision in *Lipson* seems to leave open the possibility that this may be so. (See "GAAR and Lipson: Evolution or Revolution," in *Tax for the Owner-Manager*, July 2006, for a comment on the Tax Court's decision in *Lipson*.)

Mr. and Mrs. Lipson wanted to buy a house and needed $562,500 to finance the purchase price. Mr. Lipson owned all the shares of a private corporation with substantial value. Mrs. Lipson purchased some of those shares (with a value of $562,500) from him, financing the purchase with an overnight bank loan. Mr. Lipson used the proceeds of the share sale to buy the house. The next day, the house was mortgaged to the bank and the proceeds of the mortgage were used to repay Mrs. Lipson's bank loan.

Mr. and Mrs. Lipson did not elect out of the provisions of section 73, with the consequence that the transfer of shares took place at Mr. Lipson's ACB, and any income or loss realized by Mrs. Lipson on the shares was attributable to him. The interest expense incurred by Mrs. Lipson on the share purchase loan exceeded the dividend income on the shares in the applicable years under assessment. Mr. Lipson reported the loss, taking the position that he was required to do so under section 73. The CRA disagreed, and reassessed on the basis that allowing him an interest deduction in these circumstances was abusive within the meaning of subsection 245(4).

The Tax Court upheld the reassessments on the basis that the "overall purpose" of the series of transactions was to make interest deductible on the purchase of a personal residence (2006 TCC 148, paragraph 23). The court concluded that, given this purpose, the result was abusive of paragraph 20(1)(c) and section 73 and dismissed the appeal. In the Federal Court of Appeal, the issue was said to be "whether [the trial judge] was entitled to take the overall purpose of the transactions into account in his misuse and abuse analysis and attribute to this purpose the weight that he did." The court held that he was, and in my view this is the point of special interest in the case.

In *Canada Trustco*, the Supreme Court directed that in a GAAR analysis, a court is to 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 Court of Appeal in *Lipson* conducted just such a review of the applicable provisions and concluded that "if the transactions are considered without regard to the overall purpose

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identified by . . . [the trial judge], it is difficult to find that there has been a misuse or abuse of any of the provisions relied upon. This is the conclusion that one must reach when regard is had to . . . [the trial judge's] assessment of the object, spirit and purpose of the relevant provisions." Nonetheless, the Court of Appeal held that GAAR was to be applied because the overall purpose was abusive.

In reaching its decision, the FCA said that the Supreme Court had made it clear in *Canada Trustco* that where there is no error on the part of the trial judge in the construction of the relevant provisions or in the analytical approach, the judge's finding that the planning is abusive ought not to be disturbed by an appellate court. In *Lipson*, the FCA said that it could find no basis for disagreeing with the trial judge's decision, and dismissed the appeal.

It seems to me that the key finding at trial (and accepted on appeal) was with respect to the application of paragraph 20(1)(c) to the borrowing by Mrs. Lipson to buy the shares. The finding that the borrowing of the money to buy the shares, taken by itself, did not result in a misuse of paragraph 20(1)(c) must mean that the purchase of the shares was legally effective and not a sham. On this basis, the "used for the purpose" test was met, and the interest on the loan was deductible. This approach to the paragraph accords with that in *Singleton* (2001 SCC 61), where the Supreme Court made the point that it is the direct *use* of the borrowed money that counts, not the *purpose* for which it may have been borrowed. The only conclusion I can draw from this is that there was no misuse of paragraph 20(1)(c) here. It must follow from this that the purchase of the shares by Mrs. Lipson was a real transaction and effective for tax purposes.

If this is a correct reading of the findings, it seems somewhat perverse for both courts to then say that if one looks at the series overall, the result is abusive. Doing so seems perilously close to saying that "in substance" the money was borrowed to finance the purchase of the house, notwithstanding that it was borrowed for an admittedly qualifying purpose. In *Canada Trustco*, the Supreme Court warned against approaching a GAAR issue in this way, directing trial judges to make a textual, contextual, and purposive analysis of the relevant sections and not to engage in speculation about some overarching policy of the Act. Only if one can find a misuse of paragraph 20(1)(c) in *Lipson* is the decision supportable, and that conclusion is appropriate only if the share purchase was ineffective or a sham. One is tempted to conclude that the fact that Mrs. Lipson was Mr. Lipson's wife and not a third party may have influenced the court's thinking on this point, although there is no express suggestion of this in the reasons for judgment in either court.

One of my professors in law school (on a visit to the school from England) observed in the course of a lecture on the law of contracts that the evolution of the common law "has all of the delightful uncertainty of the fox hunt." I am put in mind of this when I try to place the *Lipson* decision in context. The fact that I think the case goes too far in applying GAAR is not the point. It is now a decision of the Federal Court of Appeal, and we all must come to grips with the notion that arrangements that do not offend or frustrate the purposes of individual provisions of the Act may, if employed in combination, be regarded as abusive. The challenge now will be to determine when such a result is called for.

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