The Legacy of UK Tax Concepts in Canadian Income Tax Law

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The Legacy of UK Tax Concepts in Canadian Income Tax Law

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Abstract

This article examines a specific category of legal transfers between the United Kingdom and Canada; namely, the legacy of UK tax concepts in Canadian income tax law. Two main areas are considered where, in our view, this influence has been most profound: (i) the concept of income deployed for Canadian tax purposes; and (ii) judicial approaches to statutory interpretation and tax avoidance. Although the rules and concepts that Canadian courts and legislatures have adopted in each of these areas have necessarily evolved over time, the path of this evolution as well as current approaches reflect the enduring influence of UK tax concepts on Canadian income tax law. The first substantive section examines the structure and concept of income in Canadian tax law, linking its origins and development to the global and schedular taxes that were adopted in the United Kingdom in 1799 and 1803, and to the source and trust concepts that UK courts have employed to interpret the meaning of income for tax purposes. The next section considers judicial approaches to the interpretation of tax statutes and tax avoidance in Canada, tracing the origins of a strict construction approach to interpretation and a formalistic approach to the characterisation of transactions and relationships to early judicial decisions in the UK, and explaining the influence of this traditional approach on subsequent legislative and judicial developments. The final section concludes that the traditional approach endures, albeit uneasily, in Canadian income tax law in the continuing emphasis on textual interpretation of tax legislation and in the formalist application of the general anti-avoidance rule by the Supreme Court of Canada.

Introduction

AMONG legal sociologists, it is often argued that so-called "legal transplants" in which legal rules are transferred from one jurisdiction to another are virtually impossible.[1] To the extent that legal rules are given concrete meaning within the social and legal context in which they are interpreted and applied, this observation is necessarily true, but also somewhat trite. While the metaphor of a legal "transplant" may be exaggerated,[2]

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[1] See, e.g. P. Legrand, "What 'Legal Transplants'?" in *Adapting Legal Cultures* (D. Nelken and J. Feest (eds), Hart Publishing, Oxford, 2001) at 55, criticising A. Watson, *Legal Transplants: An Approach to Comparative Law* (Scottish Academic Press, Edinburgh, 1974).

[2] See, e.g. D. Nelken, "Legal Transplants and Beyond: Of Disciplines and Metaphors" in *Comparative Law in the 21st Century* (A. Harding and E. Örücü (eds), Kluwer Academic Publishers, London, 2002) at 19.

suggesting that the transplanted legal rule remains largely intact within the host legal system,[3] the phenomenon of legal transfers is well-established in comparative legal scholarship and central to the categorisation of legal traditions or families with common characteristics and approaches.[4] Where legal rules and concepts are transferred between jurisdictions with similar legal traditions and socio-economic characteristics, moreover, one might expect a strong resemblance between the transferred rule or concept and its original version. This is particularly so for legal transfers between the United Kingdom and a developed Commonwealth country like Canada, where the legal system is generally derived from UK sources,[5] appeals to the Judicial Committee of the Privy Council existed until 1949,[6] and a shared legal culture is fostered by educational and professional exchanges and graduate education in the United Kingdom.[7]

It would be impossible in an article such as this to do justice to the multitude of UK tax concepts that have influenced Canadian income tax law.[8] Nevertheless, it is possible to show that UK tax concepts have had considerable influence in the structure and development of Canadian income tax law, affecting Canadian tax law's concept of income as well as judicial approaches to the interpretation of tax statutes and to tax avoidance. With respect to the concept of income, Canadian courts have been influenced by UK source and trust concepts of income as well as the schedular nature of the UK income tax, which has significantly affected Canadian judicial decisions notwithstanding the global character of the Canadian income tax. In response to judicial decisions based on these UK tax concepts, the federal Income Tax Act (ITA) has often been amended to extend the breadth of the tax. These amendments, like the judicial decisions they have reversed, as well as subsequent judicial decisions in which they have been considered, remain as an enduring legacy of UK tax concepts in Canadian income tax law. Although the rules and concepts that Canadian courts and legislatures have adopted have necessarily evolved over time, as they have in the United Kingdom itself, the path of this evolution as well as current approaches reflect the complex interplay of UK tax concepts and those of other jurisdictions both directly and indirectly on Canadian income tax law.[9]

3 On the other hand, even a metaphor of a "transplant" implies some adaptation as the transplant may fail if it is rejected by the host. See Nelken, fn.2 at 27.

4 See generally K. Zweigert and H. Kötz, *Introduction to Comparative Law* (T. Weir trans., 3rd rev. ed., Clarendon Press, Oxford, 1998).

5 The major exception to this pattern is the private law of Quebec, which is civilian.

6 Cases that were already underway at the time that appeals to the JCPC were abolished were permitted to appeal, which explains why the practice of appealing to the JCPC continued into the mid-1950s. See, e.g. *MNR v Anaconda American Brass Ltd* [1955] CTC 311; 55 DTC 1220, PC.

7 This last factor has waned over the last 30 years as Canadian-trained graduate students in law are now more likely to study in the United States than the United Kingdom.

8 Consider as indirect evidence Peter Harris's historical work on income taxes in common law jurisdictions. The treatment Harris gives to income tax from the inception to 1820 runs to 514 pages. See P. Harris, *Income Tax in Common Law Jurisdictions: From the Origins to 1820* (CUP, Cambridge, 2006). On the evolving approach of the UK courts to interpretation and tax avoidance, see J. Freedman, "Interpreting Tax Statues: Tax Avoidance and the Intention of Parliament" (2007) 123 LQR 52.

9 To the extent that Canadian courts and legislatures draw on tax concepts from other jurisdictions as well as the United Kingdom (for example, the United States, from which Canada derived its controlled foreign corporation rules), it is possible to speak of a convergence in tax systems, particularly among developed countries. Notwithstanding this convergence, marked distinctions among different legal families remain, resulting in continuing affinities in tax concepts among jurisdictions belonging to the same legal family. For useful discussions regarding convergence among tax systems as well as

With respect to interpretation and tax avoidance, Canadian courts originally adopted the strict and literal approach that UK courts embraced from the mid-nineteenth century to the 1970s as well as the formalist approach to the characterisation of transactions and legal relationships that the House of Lords adopted in the *Duke of Westminster* case.[10] Although Canadian courts began to depart from this approach in the 1980s, the legacy of strict and literal interpretation and formalistic characterisation endures in the detailed and prolix manner in which income tax legislation is drafted, the multitude of provisions designed to plug gaps created by restrictive judicial interpretations, the variety of specific anti-avoidance rules (SAARs) designed to limit avoidance opportunities, and the introduction in 1988 of a statutory general anti-avoidance rule (GAAR).

Despite the Supreme Court of Canada's emphasis during the 1980s and early 1990s on purposive interpretation and substantive characterisation, moreover, the traditional judicial approach resurfaced from the mid-1990s to the early 2000s as the Supreme Court of Canada adopted a more literal interpretative approach and a more formalist approach to the characterisation of transactions and relationships for tax purposes. While several more recent Supreme Court of Canada decisions suggest a greater willingness to interpret tax provisions in light of their context and purpose, the traditional approach endures in a continuing emphasis on textual interpretation of tax legislation and in a formalist approach to the application of the GAAR that seeks to synthesise the traditional *Duke of Westminster* principle with the antithetical approach exemplified by the GAAR.

The structure and concept of income in Canadian income tax law

Canada's federal income tax was first enacted in 1917, with the declared purpose of helping fund the country's participation in the First World War.[11] Although some provinces had enacted their own income taxes before this date,[12] and all provinces currently levy income taxes under their constitutional power to make laws relating to "Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes,"[13] the federal government assumed a dominant role in Canadian income taxation during the Second World War and has retained it ever since through tax collection agreements under which the federal government is prepared to collect provincial income tax on each province's

differences among different families of tax systems, see V. Thuronyi, *Comparative Tax Law* (Kluwer Law International, The Hague, 2003) at 15 and 23.

[10] *IRC v Duke of Westminster* 19 TC 490; [1936] AC 1.

[11] *Income War Tax Act*, S.C. 1917, c. 28. For a provocative account of the introduction of the Canadian income tax, arguing that it was "a purely political act . . . by the government of the day to attract candidates and votes in a crucial wartime election" see R. Krever, "The Origin of Federal Income Taxation in Canada" (1981) 3 *Canadian Taxation* 170 at 171.

[12] British Columbia introduced a provincial personal income tax in 1876 and Prince Edward Island did so in 1894. E. H. Smith, *Federal-Provincial Tax Sharing and Centralized Tax Collection in Canada* (Canadian Tax Foundation, Toronto, 1998) at 8.

[13] Constitution Act, 1867, 30 & 31 Victoria, c.3. s.92(2) (UK). According to s.91(3) of the Constitution Act, 1867, the federal government may make laws relating to "The raising of Money by any Mode or System of Taxation." As a result, both federal and provincial governments have the constitutional authority to levy income taxes. See G. V. La Forest, *The Allocation of Taxing Power Under the Canadian Constitution* (2nd ed., Canadian Tax Foundation, Toronto, 1981).

behalf provided that the province adopts the same definition of taxable income as the federal legislation.[14]

As a former colony, with significant legal and cultural connections to the United Kingdom, it is not surprising that Canada might look to UK legislation when drafting its first federal income tax. There, the income tax applied separately to five different types of income—income from lands derived by owners (Schedule A), income from lands derived by occupiers (Schedule B), annuities and dividends paid on government securities (Schedule C), annual profits and gains from property, professions, trades, employments and vocations (Schedule D), and income from public offices and employments (Schedule E)—reflecting the schedular structure of Addington's 1803 income tax, which was repealed in 1816 but reinstated in 1842.[15] Before Addington, however, Pitt's 1799 income tax had applied on a global basis to "all income" from various sources—lands, tenements and hereditaments (Cases 1–14), trades, professions, offices, pensions, stipends, employments and vocations (Case 15), offices, pensions, stipends, annuities, interest, rent or similar payments including annuities and dividends paid on government securities (Case 16), income arising outside Great Britain (Cases 17–18), and "any income not falling under the above heads" (Case 19).[16]

Notwithstanding significant differences in the *structure* of these taxes, both share a similar *concept* of income in the form of various productive sources from which income is derived, such as property, professions, trades, employments, vocations, and offices.[17] Based on prevailing economic theories at the time, this source concept of income bears a striking resemblance to the account provided by Adam Smith in *The Wealth of Nations*,[18] who defined income in terms of four productive sources: wages of labour, trading profits, interest on financial capital, and rent of land.[19] Together with this source concept, UK

[14] For a detailed discussion of these tax collection agreements, see Smith, fn.12 at Chs 9–12. Each province (except Quebec) has entered into a tax collection agreement with the federal government for personal income taxes.

[15] See A. Likhovski, "A Map of Society: Defining Income in British, British Colonial and American Tax Legislation" [2005] BTR 158 at 163. For a detailed explanation of Addington's 1803 income tax, see P. E. Soos, *The Origins of Taxation at Source in England* (IBFD Publications BV, Amsterdam, 1997) at 152. See also M. Daunton, "What is Income?" in *Studies in the History of Tax Law* (J. Tiley (ed), Hart Publishing, Oxford, 2004) at 3.

[16] An Act to Repeal the Duties Imposed by an Act, Made in the Last Session of Parliament, for Granting and Aid and Contribution for the Prosecution of the War, and to Make More Effectual Provision for the Like Purpose, by Granting Certain Duties upon Income, in Lieu of the Said Duties, 39 Geo. 3, c.13. For an excellent summary of the 1799 income tax, see Soos, fn.15 at 147–52. For various reasons, Pitt's tax was not well received, and the tax was repealed in 1802. See Likhovski, fn.15 at 163 (explaining that merchants objected to the inspection of their books and records and to the disclosure of their total income for the year); and Daunton, fn.15 at 4 (observing that compliance and collection were more difficult under Pitt's global approach than Addington's schedular tax which was administered through deductions at source).

[17] On the distinction between the "definitional structure" of an income tax and the "concept of income" that it employs, see Thuronyi, fn.9 at 233–35.

[18] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776 (University of Chicago Press, Chicago, 1976).

[19] See Smith, fn.18 at 59 (Bk I, Ch. VI): "Whoever derives his revenue from a fund which is his own, must draw it either from his labour, from his stock, or from his land. The revenue derived from labour is called wages. That derived from stock, by the person who manages or employs it, is called profit. That derived from it by the person who does not employ it himself, but lends it to another, is called the interest or the use of money. . .. The revenue which proceeds altogether from land, is called rent,

courts traditionally interpreted the concept of income according to trust law distinctions between capital and income, characterising capital gains and other non-recurring revenues like gifts and windfalls as non-taxable receipts rather than income from a source.[20] On this basis, as Rowlatt J. declared in *Ryall v Hoare*:

> "First, anything in the nature of capital accretion is excluded as being outside the scope and meaning of these Acts confirmed by the usage of a century. For this reason, a casual profit made on an isolated purchase and sale, unless merged with similar transactions in the carrying on of a trade or business is not liable to tax. "Profits or gains" in Case 6 refer to the interest or fruit as opposed to the principal or root of the tree. The second class of cases to be excluded consists of gifts and receipts whether the emolument is from a gift *inter vivos* or by will or from finding an article of value or from winning a bet. All these cases must be ruled out because they are not profits or gains at all."[21]

While the former receipts were characterised as non-taxable capital gains from the realisation of an investment, the latter were characterised as non-taxable gains from the transfer of property rather than the creation of new wealth.[22]

In addition to the United Kingdom, Canadian drafters might also have looked to the United States, which enacted the predecessor to its current income tax only four years earlier, in 1913.[23] According to a revised version of this legislation enacted in 1916, the "net income of a taxable person" was defined to include:

> "gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."[24]

Like Pitt's 1799 income tax, this income tax was global in structure, applying to a taxpayer's "gains or profits and income derived from any source whatever." In contrast to the United Kingdom, however, the concept of income contained in this definition is arguably broader than the source and trust concepts adopted by UK courts, including not only income from various productive sources such as "professions, vocations, trades

and belongs to the landlord. . . . All taxes, and all the revenue which is founded upon them . . . are ultimately derived from some one or other of those three original sources of revenue, and are paid either immediately or mediately from the wages of labour, the profits of stock, or the rent of land."

[20] J. Tiley, *Revenue Law* (4th ed., Hart Publishing, Oxford, 2000) at 131. On the significance of the trust concept of income for the taxation of capital gains, see L. H. Seltzer, "Evolution of the Special Status of Capital Gains Under the Income Tax" (1950) 3 Nat'l Tax J. 18. As Tiley explains (at 132) the distinction between capital and income may also be linked to the economic thought of Adam Smith, who distinguished between circulating capital which yields recurring profits through successive exchanges and fixed capital which yields a profit "without changing masters, or circulating any further." See Smith, fn.18 at 295 (Bk II, Ch.1).

[21] *Ryall v Hoare* [1923] 2 KB 447 at 454, KB.

[22] See the discussion in *Bellingham v Canada* [1996] 1 CTC 187; [1995] 96 DTC 6075, FCA.

[23] Revenue Act of 1913, 38 Stat. 166 (1913).

[24] Revenue Act of 1916, 39 Stat. 758 (1916).

and businesses," but also income derived in various forms such as "salaries, wages, or compensation for personal service," as well as "gains" and "profits" more generally. In the context of this statutory definition, the US Supreme Court held that the US income tax applies to realised capital gains,[25] gifts and inheritances,[26] and other non-recurring receipts such as punitive damages.[27] In *Commissioner v Glenshaw Glass Co*,[28] moreover, the Court affirmed a different concept of income than the UK source and trust concepts, explaining that punitive damages were taxable as "undeniable accessions to wealth . . . over which the taxpayers have complete dominion."[29] In contrast to the source and trust concepts of income, therefore, the US courts developed an accessions concept of income.

Whatever the actual references consulted by the drafters of the Canada's first federal income tax, the definition of income in this legislation appears to reflect both English and American influences. According to subsection 3(1) of the Income War Tax Act (IWTA), income was defined as:

> "the annual net profit or gain or gratuity . . . received by a person from any office or employment, or from any profession or calling or from any trade, manufacture or business . . . the interest, dividends or profits . . . received from money . . . or from stocks, or from any other investment, . . . and also the annual profit or gain from any other source."[30]

Like the US income tax and Pitt's 1799 income tax, therefore, the IWTA adopted a global approach to the definition of income, including all net profits or gains from "any . . . source." Like the UK income taxes, the IWTA also employed a source concept of income, defining income as profits, gains or gratuities from various productive sources such as offices, employments, professions, callings, trades, manufactures, businesses, money, stocks or other investments. These two features have endured through subsequent amendments to the federal income tax, which have consistently included a taxpayer's income from all sources inside and outside Canada, while simultaneously identifying specific sources of income "without restricting the generality" of the inclusion of income from all sources.[31] Since 1948, the main sources of income that have been specified for

[25] *Eisner v Macomber* (1920) 252 US 189. Although the court held that the US Revenue Act of 1916 applied to capital gains, the decision also held that the concept of income suggested by the 16th amendment to the US Constitution and employed in the Act did not apply to accrued gains that had not been realised through the sale or other disposition of the properly. For a detailed account of this decision and its impact on the structure of the US income tax, see M. Kornhauser, "The Story of *Macomber*: The Continuing Legacy of Realization", in *Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases* (P. Caron (ed.), Foundation Press, New York, 2003) at 53.

[26] *Irwin v Gavit* (1925) 268 US 161. Although the US income tax specifically excludes "property acquired by gift, bequest or descent," the Court held that this exemption did not apply to the bequest of an income interest in a trust.

[27] *Commissioner v Glenshaw Glass Co* (1955) 348 US 425.

[28] *Commissioner v Glenshaw Glass Co* (1955) 348 US 425.

[29] *Commissioner v Glenshaw Glass Co* (1955) 348 US 425 at 431. For a detailed account of this decision and its impact on the concept of income in the US income tax, see J.M. Dodge, "The Story of *Glenshaw Glass*: Towards a Modern Concept of Gross Income", in Caron (ed.), fn.25 at 15.

[30] S.C. 1917, c.28.

[31] See Income Tax Act, S.C. 1948, c.52, s.3 (ITA 1948); Income Tax Act, R.S.C. 1952, c.148, s.3 (as amended) (ITA 1952); and Income Tax Act, S.C. 1970-71, c. 63, para.3(a); and Income Tax Act, R.S.C. 1985, c.1 (5th Supp.) (as amended) (ITA).

this purpose are businesses, properties, offices and employments,[32] though these have also been supplemented by other categories of income such as pensions and alimony,[33] and (since 1972) taxable capital gains.[34] As a general rule, these categories of income are subject to a detailed set of computational rules defined by the federal income tax statute.[35] Since 1960, the computational rules for computing a taxpayer's income from each source have been premised on an explicit statutory presumption that the taxpayer has no income or loss except from the particular source and is allowed no deductions except those that "may reasonably be regarded as wholly applicable to that source . . . and except such part of any other deduction as may reasonably be regarded as applicable thereto".[36] In this respect, as with other rules limiting the deduction of certain kinds of losses to income of a similar type,[37] the structure of Canada's global income tax contains various schedular aspects.[38]

While Canadian judges might have looked to US tax decisions to help interpret Canada's federal income tax legislation, the dominant legal culture at the time and the ability to appeal to the Judicial Committee of the Privy Council ensured that the concept of income for Canadian tax purposes would continue to be influenced by UK concepts and principles. In *Spooner v MNR*,[39] decided by the Judicial Committee of the Privy Council in 1933, oil and gas royalties received by the taxpayer as partial consideration for the sale of land to an oil and gas company were characterised as non-taxable capital receipts, not annual profits or gains within the meaning of the IWTA. Consistent with this approach, the Supreme Court of Canada emphasised the distinction between income and its source in a 1939 decision in which it rejected the Minister's argument that life insurance proceeds were fully taxable as annual net profits or gains on the basis that the proceeds reflected a capital element attributable to the payment of premiums by the taxpayer's deceased husband. According to Duff C.J.C.:

> "The legislature, is seems to me, is at pains to emphasize the distinction between income and the source of income. The income derived from the capital source is income for the purposes of the Act. The source is not income for the purposes of the Act."[40]

[32] Since 1948, the Canadian statute has also included statutory definitions for each of these sources of income, which generally expand upon the ordinary meaning of these words. See, e.g. the definitions of "business", "employment", "office" and "property" in s.248(1) of the ITA.

[33] See paras 6(1)(a) and (d) of ITA 1948 and ITA 1952, and paras 56(1)(a) and (b) of the ITA.

[34] See para.3(b) of the ITA, which generally requires taxpayers to include the amount by which their taxable capital gains for the specific taxation year exceeds their allowable capital losses for the year.

[35] See, e.g. ITA, ss.5–8 (income from an office or employment), 9–37 (income from a business or property), 38–55 (taxable capital gains and allowable capital losses), and 56-59.1 (other sources of income).

[36] ITA 1952, para.139(1a)(a), added by 1960, c.43, s.33(5), applicable to 1960 and subsequent taxation years. Since 1972, this rule appears in ITA, para.4(1)(a).

[37] See, e.g. ITA, para.3(b) (generally limiting the deduction of a taxpayer's allowable capital losses for a taxation year to the aggregate of the taxpayer's taxable capital gains for the year); s.18(12) (limiting the deduction of home office expenses in respect of a business to net income otherwise computed from the relevant business); and section 31 (limiting the deduction of farm losses).

[38] The introduction of schedular elements in global income taxes is increasingly common in developed and developing countries alike. See Thuronyi, fn.9 at 241–43.

[39] *Spooner v MNR* [1933] AC 684; [1928–34] CTC 184; [1933] 1 DTC 258, PC.

[40] *Shaw v MNR* [1939] SCR 338 at [9].

Twelve years later, the Supreme Court of Canada reaffirmed the distinction between income and capital receipts, characterising annuity payments that the taxpayer received in consideration for the sale of his real estate business as a "capital payment" and not as income within the meaning of the IWTA.[41]

Based on the source and trust concepts of income that UK courts had employed to interpret the meaning of income for UK tax purposes, Canadian courts concluded not only that capital payments were not subject to income tax, but that the concept of income for Canadian tax purposes did not extend to capital gains,[42] non-competition payments,[43] damages for personal injuries,[44] gifts,[45] prizes,[46] gambling proceeds and lottery winnings,[47] and other unexpected and non-recurring receipts that Canadian courts have generally characterised as windfalls.[48] In *The Queen v Cranswick*,[49] for example, where a minority shareholder of Westinghouse Canada Limited received a payment from the company's majority shareholder in order to "avoid . . . controversy or potential litigation" after the company sold its household appliance division at an unfavourable price, the Federal Court of Appeal characterised the payment as a non-taxable "windfall"

41 *Wilder v MNR* [1952] 1 SCR 123 at [8], per Rinfret C.J.C.

42 See, e.g. *Irrigation Industries Ltd v MNR* [1962] CTC 215; 62 DTC 1131, SCC, characterising gains on the sale of speculative shares acquired from the issuer and held for only a few weeks or months as non-taxable capital gains from the realisation of an investment.

43 See, e.g. *Fortino v The Queen* (1996) [1997] 2 CTC 2184; 97 DTC 55, TCC, concluding that non-competition payments are capital receipts that are not subject to tax as income from an unspecified source. See also *Manrell v The Queen* [2003] 3 CTC 50; 2003 DTC 5225, FCA, which also concluded that non-competition payments are not taxable as capital gains on the basis that a right to compete is not "property" the disposition of which is essential to the definition of a capital gain under the ITA.

44 *Cirella v The Queen* [1978] CTC 1; 77 DTC 5542, FCTD, concluding (at [17]) that damages for personal injuries are "of a capital rather than an income nature".

45 See, e.g. *Federal Farms Ltd v MNR* [1959] CTC 98; 59 DTC 1050 (Ex. Ct.), characterising (at [19]) compensation received by the taxpayer from a relief fund established after a hurricane swept through the Toronto area as a payment "in the nature of a voluntary personal gift and nothing more."

46 See, e.g. *Rother v MNR* (1955) 12 Tax ABC 379; 55 DTC 277, TAB, characterising (at [8]) a cash payment won by the taxpayer architect in a design competition for the National Gallery of Canada as a non-taxable receipt "in the nature of a prize or gratuitous award received in the course of a competition." See also *Abraham v MNR* (1960) 24 Tax ABC 133, TAB, concluding (at [13]) that a cash payment received by the taxpayer in lieu of a car won in a draw was "in the nature of a non-taxable prize."

47 See, e.g. *MNR v Morden* [1961] CTC 484; 61 DTC 1266, Ex. Ct., characterising (at [15]) the taxpayer's betting activities during the years in question as a "hobby" that did not constitute "an enterprise of a commercial character" that was "so organized . . . as to make them a business, calling or vocation." See also *Leblanc v The Queen* [2007] 2 CTC 2248; 2007 DTC 307, TCC, concluding (at [41]) that the taxpayers' gambling activities were "of a personal nature" and therefore not subject to tax.

48 See, e.g. *Cameron v MNR* [1971] Tax ABC 645, TAB, in which the taxpayer, who carried on a fishing business, received a share of the proceeds from the sale of killer whales that he helped to capture on two occasions while engaged in his fishing business. Concluding (at [9]) that the taxpayer was "a professional salmon fisherman and not a whaler" the Board accepted the taxpayer's argument (at [7]) that "the money received was a windfall and not income" on the basis (at [9]) that the gain was "fortuitous" and "not a business venture in the usual sense." See also *Bellingham v The Queen* (1995), [1996] 1 CTC 187; 96 DTC 6075, FCA, characterising (at [41]) a punitive damage award received by the taxpayer as a non-taxable "windfall gain" not on the grounds that it was non-recurring or not derived from a productive source, but on the basis that the payment did not "flow from either the performance or breach of a market transaction."

49 *The Queen v Cranswick* [1982] CTC 69; 82 DTC 6073, FCA.

on the basis that the payment "was not income earned by or arising from the respondent's shares, which are the only possible source of income in this case."[50]

Notwithstanding the primarily global structure of the Canadian income tax, moreover, Canadian courts have generally interpreted the statute in a schedular manner, regularly excluding various receipts from tax on the basis that they are not specifically included in the statutory text.[51] In *Fries v Canada*,[52] for example, the Supreme Court of Canada held that strike pay was not taxable as income from an unspecified source on the basis that "the benefit of the doubt must go to the taxpayers."[53] In *The Queen v Atkins*,[54] the Federal Court of Appeal held that a payment received by the taxpayer in lieu of notice of dismissal from his employment was neither income from the taxpayer's employment nor income from an unspecified source, on the grounds that the payment was neither contemplated by the specific statutory provisions governing a taxpayer's income from an office or employment,[55] nor "remuneration for services".[56] Without considering whether payments might be income from an unspecified source, other cases held that compensation received by a taxpayer on the cancellation of options to acquire securities was not included in computing the taxpayer's income from an office or employment on the grounds that the options had not been "transferred or otherwise disposed of" as required by the statutory provision governing employment benefits in respect of these options.[57] More recently, however, a majority of the Supreme Court of Canada adopted a different approach, concluding that a lump-sum payment in settlement of a claim for disability benefits was taxable under a specific provision for employment insurance benefits on the basis that the payment was intended to replace an amount that, if received, would have been taxable.[58] As this application of the so-called *surrogatum* principle appears to depart from cases involving payments in lieu of notice and compensation for the cancellation of stock options, however, it is uncertain whether this novel judicial approach will endure.

[50] *The Queen v Cranswick* [1982] CTC 69; 82 DTC 6073, FCA at [15].

[51] For a rare exception to this pattern, the statutory basis of which is not entirely clear, see *Curran v MNR* [1959] CTC 416; 59 DTC 1247, SCC, in which the Court held that an inducement payment to encourage the taxpayer to leave his former employment and commence employment with a company controlled by the payer of the inducement was taxable as remuneration for services.

[52] *Fries v Canada* [1990] 2 CTC 439, SCC.

[53] *Fries v Canada* [1990] 2 CTC 439, SCC at [2]. For a critical analysis of this result, see B. Alarie and M. Sudak, "The Taxation of Strike Pay" (2006) 54 *Canadian Tax Journal* 426.

[54] *The Queen v Atkins* [1976] CTC 497, 76 DTC 6258, FCA.

[55] *The Queen v Atkins* [1976] CTC 497, 76 DTC 6258, FCA at [3] and [4], explaining that the payments could not be regarded as "salary", "wages" or "remuneration" or as a benefit "received or enjoyed . . . in respect of, in the course of, or by virtue of the office or employment" nor as deemed remuneration within the meaning of a specific anti-avoidance rule designed to tax other kinds of consideration received by officers and employees.

[56] *The Queen v Atkins* [1976] CTC 497; 76 DTC 6258, FCA at [5], concluding that judicial decisions holding that remuneration for services is income from a source even if not income from an office or employment "have no application to damages for wrongful dismissal."

[57] *Huestis v MNR* [1975] CTC 85; 75 DTC 5042, FCTD, affirmed [1975] CTC 560; 75 DTC 5393, FCA, affirmed [1976] CTC 792; 77 DTC 5044, SCC; *Bernier v The Queen* [2000] 1 CTC 347; 2000 DTC 6053, FCA; and *Buccini v The Queen* [2000] 1 CTC 103; 2000 DTC 6685, FCA.

[58] *Tsiaprailis v The Queen* [2005] 2 CTC 1; 2005 DTC 5119, SCC, citing the UK decision in *London and Thames Haven Oil Wharves Ltd v Attwooll* [1967] 2 All ER 124, CA.

As in the United Kingdom, which introduced a tax on capital gains in 1965,[59] judicial decisions based on source and trust concepts of income or a schedular interpretive approach have often been reversed by legislative amendment.[60] In response to the Privy Council decision in *Spooner*,[61] for example, the federal government amended the IWTA in 1934 to include "rents, royalties, annuities or other like periodical receipts which depend upon the production or use of any real or personal property, notwithstanding that the same are payable on account of the use or sale of any such property."[62] In a subsequent decision under an amended version of this provision,[63] however, the Exchequer Court applied a schedular interpretative approach, excluding a lump sum payment in satisfaction of the taxpayer's right to periodical receipts based on the production or use of his property, on the basis that the provision did not include payments "in lieu of payment of, or in satisfaction of" amounts depending upon the production or use of property.[64]

In 1972, prizes were added as income from an "other" source, but only where they are received "for achievement in a field of endeavour ordinarily carried on by the taxpayer".[65] In applying this provision, Canadian courts continue to employ a source concept of income, concluding in one leading case that the "achievement" requirement "rules out, for example, prizes won in games of chance or at a costume party or for athletic achievement."[66] In another case, in which an unemployed cinema manager won a cash prize on a television game show by answering questions on Quebec cinema, Charles de Gaulle and Charlie Chaplin, the court held that the prize was not taxable on the basis that "it is difficult to regard the vast field of culture as an individual's ordinary field of endeavour" within the meaning of the statutory provision.[67]

After the Federal Court of Appeal decision in *Atkins*,[68] the ITA was amended to include payments in lieu of notice as "retiring allowances" that (like prizes) are specifically included as income from an "other" source.[69] In *Schwartz v The Queen*,[70] however, the Supreme Court of Canada refused to apply this provision to compensation for the breach of an

[59] J. Tiley, "General Description: United Kingdom", in *Comparative Income Taxation: A Structural Analysis* (H. J. Ault (ed.), Kluwer Law International, The Hague, 1997) at 113.

[60] See, e.g. s.7(1.7) of the ITA, which reverses the decisions in *Huestis* [1975] CTC 85; *Bernier* [2000] 1 CTC 347 and *Buccini v The Queen* [2000] 1 CTC 103, by deeming the cancellation of options to be a transfer or disposition of the options and deeming compensation received by the taxpayer in respect of the cancellation of options to be proceeds from the transfer or disposition. See also proposed s.56.4 of the ITA, which will reverse the decisions in *Fortino* [1997] 2 CTC 2184 and *Manrell* [2003] 3 CTC 50, by including non-competition payments as income from an "other" source.

[61] *Spooner v MNR* [1933] AC 684; [1928–34] CTC 184; [1933] 1 DTC 258, PC.

[62] IWTA, para.3(1)(f).

[63] See ITA 1952, para.6(1)(j), which included "amounts received by the taxpayer in the year that were dependent upon the use or production from property, whether or not they were instalments of the sale price of the property . . .." This provision is now para.12(1)(g) of the ITA.

[64] *MNR v Morrison* [1966] CTC 558 ; 66 DTC 5368, Ex. Ct. at [13].

[65] See para.56(1)(n) of the ITA.

[66] *The Queen v Savage* [1983] CTC 393; 83 DTC 5409, SCC at [33].

[67] *Turcotte v The Queen* [1997] 3 CTC 2359, TCC at [35].

[68] *The Queen v Atkins* [1976] CTC 497.

[69] See ITA, para.56(1)(a)(ii) and the definition of "retiring allowance" in of the ITA, s.248(1). According to para.(b) of this definition, a retiring allowance includes an amount received "in respect of a loss of an office or employment of a taxpayer, whether or not received as, on account or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal".

[70] *Schwartz v The Queen* [1996] 1 CTC 303; 96 DTC 6103, SCC.

employment contract before the taxpayer commenced the duties of his employment, on the grounds that the statutory definition of a "retiring allowance" included only amounts received "in respect of a loss of an office or employment," not the loss of an "intended" office or employment.[71] Adopting a *de facto* schedular approach despite its affirmation to the contrary,[72] moreover, the Court also held that the payment was not taxable as income from an unspecified source on the basis that Parliament intended that these payments should be governed by the specific provision for retiring allowances[73]—despite its subsequent conclusion within the structure of the judgment that this specific provision did not, in fact, apply!

Most importantly, of course, after the Canadian Royal Commission on Taxation (Carter Commission) recommended a "comprehensive tax base" along the lines of the US accretion concept of income,[74] the ITA was amended in 1972 to make capital gains partly taxable (and capital losses partly deductible)—including half of these gains in computing a taxpayer's total income for the year as taxable capital gains and allowing half of capital losses to be deducted against these taxable capital gains as allowable capital losses.[75] Although the partial recognition of these gains and losses reduces the practical significance of the distinction between income and capital receipts, the distinction remains as a prominent manifestation of the continuing influence of UK tax concepts on the structure and concept of income in Canadian tax law.

Judicial approaches to the interpretation of tax statutes and tax avoidance

Judicial approaches to the application of tax statutes involve two related aspects: interpretation of the relevant statutory text, and characterisation of the transactions and relationships to which the statute applies. To the extent that taxpayers engage in tax-motivated transactions that contradict the scheme or purpose of the relevant statutory text, these aspects are necessarily linked, since textual interpretative approaches are apt to characterise transactions and relationship without regard to the economic substance of these transactions or relationships or the motivations of the parties entering into them, while more purposive approaches are more likely to characterise or re-characterise

71 *Schwartz v The Queen* [1996] 1 CTC 303; 96 DTC 6103, SCC at [55]–[63], observing that the words "an intended office or employment" were enacted at the same time in ITA, s.80.4(1), which deems taxpayers who obtain interest-free or low-interest loans "because of or as a consequence of a previous, the current or an intended office or employment" to have received a taxable benefit in respect of the loan.

72 *Schwartz v The Queen* [1996] 1 CTC 303; 96 DTC 6103, SCC at [50], declaring that "income from *all* sources, enumerated or not" are taxable under the ITA (emphasis in original).

73 *Schwartz v The Queen* [1996] 1 CTC 303; 96 DTC 6103, SCC at [52]–[54].

74 Report of the Royal Commission on Taxation, 6 vols (Queen's Printer, Ottawa, 1966).

75 See para.3(b) and subdivision c of Division B of Part I of the *Income Tax Act*, S.C. 1970–71, c.63. The taxable and allowable fractions of these gains and losses have varied over the last 20 years, rising to 2/3 and then 3/4 in the late 1980s and early 1990s, and returning to 1/2 in the year 2000. While courts and commentators have occasionally considered taxable capital gains as an additional source of income, this category of income is best understood as income from the disposition of property that may itself constitute a source of income, rather than income from a source itself. Indeed, the language of para.3(a), which separates the words "income for the year" and "from a source" by the parenthetical words "other than a taxable capital gain from the disposition of property," might be read to suggest (if somewhat awkwardly) that this category of income is not "from a source."

transactions and relationships in light of their economic substance and the objectives of the statutory scheme.

In the United Kingdom, judicial decisions in the nineteenth and early twentieth centuries held that tax statutes should be construed strictly and literally, with ambiguities in taxing provisions resolved in the taxpayer's favour.[76] In *Cox v Rabbits*,[77] for example, which was decided by the House of Lords in 1878, Lord Cairns stated that "a Taxing Act must be construed strictly; you must find the words to impose the tax, and if the words are not found which impose the tax, it is not to be imposed."[78] Similarly, in *Partington v Attorney-General*,[79] Lord Cairns declared that "the principle of all fiscal legislation" was that:

> ". . . if the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be."[80]

In other words, he explained, "if there be admissible, in any statute, what is called equitable construction, certainly such a construction is not admissible in a taxing statute where you simply adhere to the words of the statute."[81] In 1921, Rowlatt J. affirmed a similar approach in *Cape Brandy Syndicate v IRC*,[82] stating that:

> ". . . in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a

[76] The reasons for this interpretative doctrine are varied and contested. As John Tiley suggests, one justification was the absence of any antecedent relationship between the taxpayer and the taxing authority, as a consequence of which it was allegedly impossible to adopt any construction based on some *a priori* obligation on the part of the taxpayer. See Tiley, fn.20 at 51, citing *Pryce v Monmouthshire Canal and Railway Companies* (1878) 4 AC 197 at 202–203, HL, per Lord Cairns L.C. For this reason, as Lord Halsbury suggested in *Tennant v Smith* [1892] AC 50 at 54, HL, it was "impossible" in a tax statute "to assume any intention, any governing purpose in the Act, to more than take such tax as the statute imposes." Another, not unrelated, explanation for this interpretive approach regarded tax statutes as a form of penal legislation, against which courts should tilt in order to protect the liberty of the citizen. See, e.g. *Nicholls v Cumming* (1877) 1 SCR 395 at 42: "When a statute derogates from a common law right and divests a party of his property, or imposes a burthen on him, every provision of the statute beneficial to him must be observed. Therefore, it has been held, that acts which impose a charge or duty upon the subject must be strictly construed." Yet another rationale turns on the presumed ease with which the legislature can amend tax legislation to correct any deficiency attributable to a particular judicial interpretation. See, e.g. *Morguard Properties Ltd v City of Winnipeg* (1983) 3 DLR (4th) 1 at 13: ". . . the Legislature is guided and assisted by a well-staffed and ordinarily very articulate Executive. . . The resources at hand in the preparation and enactment of legislation are such that a court must be slow to presume oversight or inarticulate intentions when the rights of the citizen are involved. The legislature has complete control of the process of legislation, and when it has not for any reason clearly expressed itself, it has all the resources available to correct that inadequacy of expression." For a critical evaluation of this interpretive doctrine, see D.G. Duff, "Interpreting the *Income Tax Act*—Part 2: Toward a Pragmatic Approach" (1999) 47 *Canadian Tax Journal* 741 at 746.

[77] *Cox v Rabbits* (1878) 3 AC 473, HL.

[78] *Cox v Rabbits* (1878) 3 AC 473 at 478, HL.

[79] *Partington v Attorney-General* (1869) 4 LR 100, HL.

[80] *Partington v Attorney-General* (1869) 4 LR 100 at 122, HL.

[81] *Partington v Attorney-General* (1869) 4 LR 100 at 122, HL.

[82] *Cape Brandy Syndicate v IRC* [1921] 1 KB 64.

> tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used."[83]

Although more recent House of Lords decisions have firmly rejected this doctrine, adopting a more purposive approach to the interpretation of tax statutes,[84] the strict and literal approach continued to predominate in the United Kingdom until at least the 1970s, when it was reaffirmed by the Judicial Committee of the Privy Council in *Mangin v IRC*.[85]

Together with this approach to the interpretation of tax statutes, UK courts during this period also affirmed a formalistic approach to the characterisation of transactions and relationships for tax purposes, concluding that these should be "ascertained upon ordinary legal principles",[86] notwithstanding their economic substance or the fact that they may have been entered into primarily or solely in order to minimise taxes otherwise payable. In the leading House of Lords decision in *IRC v Duke of Westminster*,[87] for example, where the Duke of Westminster established a deed of covenant designed to convert otherwise non-deductible remuneration to his gardener into deductible "annual payments" falling under the UK Income Tax Act 1918, a majority of the House of Lords upheld the Duke's appeal against an assessment characterising the payments as non-deductible remuneration on the grounds that the deed itself stated that the gardener was not prevented from "being entitled to and claiming full remuneration for such further work as you may do"—even though the document also added that "it is expected that in practice you will be content with the provision which is being legally made for you for so long as the deed takes effect with the addition of such sum, if any, as may be necessary to bring the total periodical payments while you are still in the Duke's service up to the amount of the salary or wages which you have lately been receiving."[88] Rejecting the Commissioners' argument that the payments were in substance non-deductible remuneration, Lord Tomlin held that "the substance is that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles",[89] and denounced the "supposed doctrine" that a court may "ignore the legal position and regard what is called 'the substance of the matter'" on the basis that that "the doctrine seems to involve substituting 'the incertain and crooked cord of discretion' for 'the golden and straight metwand of the law.'"[90] Concurring, Lord Russell of Killowen drew a clear connection between the characterisation of transactions and relationships for tax purposes and the interpretation of tax statutes, criticising:

83 *Cape Brandy Syndicate v IRC* [1921] 1 KB 64 at 71.

84 See, e.g. *McGuckian v IRC* [1997] STC 918, HL; and *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51. According to Tiley, *McGuckian* was "[t]he first modern case where a majority of the House of Lords came out in favour of the purposive approach," affirming the "move" in the interpretation of tax statutes "from a literal interpretation to one based on context and designed to identify the purpose of a statute and give effect to it." Tiley, fn.20 at 52.

85 *Mangin v IRC* [1971] AC 739 at 746.

86 *IRC v Duke of Westminster* 19 TC 490 at 521; [1936] AC 1 at 20, per Lord Tomlin.

87 *IRC v Duke of Westminster* 19 TC 490; [1936] AC 1.

88 *IRC v Duke of Westminster* 19 TC 490 at 514; [1936] AC 1 at 11–12.

89 *IRC v Duke of Westminster* 19 TC 490 at 521; [1936] AC 1 at 20.

90 *IRC v Duke of Westminster* 19 TC 490 at 520; [1936] AC 1 at 19.

> ". . . the doctrine that in taxation cases the subject is to be taxed if, in accordance with a Court's view of what it considers the substance of the transaction, the Court thinks that the case falls within the contemplation of the statute. . ."

on the basis that "[t]he subject is not taxable by inference or analogy, but only by the plain words of a statute applicable to the facts and circumstances of his case."[91]

As a result, while UK courts were prepared to disregard the nomenclature used by parties in favour of the actual legal rights and obligations "ascertained upon ordinary legal principles",[92] and willing to ignore "sham" transactions that are "intended to give to third parties or the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create",[93] they would not re-characterise transactions that created real legal rights and obligations—regardless of whether they were motivated primarily or solely to avoid tax and contradicted the scheme or purpose of the relevant legislation. On the contrary, as Lord Tomlin had declared in the *Duke of Westminster* case:

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."[94]

Like the strict and literal approach to the interpretation of tax statutes, this formalistic approach to the characterisation of transactions and relationships for tax purposes endured through the 1970s.[95]

In marked contrast to the UK approach, US courts adopted a more purposive approach to the interpretation of tax legislation and a correspondingly more substantive approach to the characterisation of tax-motivated transactions that contradict the scheme or purpose of the relevant legislation. In the leading American case of *Gregory v Helvering*,[96] for example, where the taxpayer engaged in a tax-motivated corporate reorganisation intended to distribute to herself publicly-traded shares held by a private holding company without incurring tax that would otherwise apply to the distribution, the US Supreme Court upheld an assessment characterising the reorganisation as a taxable dividend on the basis that the transactions were "outside the plain intent of the statute" notwithstanding

91 *IRC v Duke of Westminster* 19 TC 490 at 524; [1936] AC 1 at 24.

92 *IRC v Duke of Westminster* 19 TC 490 at 521; [1936] AC 1 at 20.

93 *Snook v London & West Riding Investments Ltd* [1967] 1 All ER 518 at 528, CA, per Lord Diplock.

94 *IRC v Duke of Westminster* 19 TC 490 at 520; [1936] AC 1 at 19.

95 The House of Lords qualified the traditional approach in three decisions in the early 1980s, in which it developed a so-called "step-transactions doctrine" whereby it assessed the tax consequences of a series of transactions by disregarding individual steps in the series and looking at the end result of the series as a whole. See *W.T. Ramsay Ltd v IRC* [1981] STC 174; [1982] AC 300, HL; *IRC v Burmah Oil Co Ltd* [1982] STC 30, HL; and *Furniss v Dawson* 55 TC 324; [1984] AC 474, HL. Subsequent decisions in the United Kingdom appear to have limited the doctrine, characterising it as an interpretive principle rather than an independent anti-avoidance doctrine. See *McGuckian v IRC* [1997] STC 918, HL; *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6; [2001] STC 237; and *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51. For a useful discussion of developments in UK tax law over the last 25 years, see Freedman, fn.8.

96 *Gregory v Helvering* (1935) 293 US 465.

that they adhered to the text of the statutory definition for a tax-free reorganisation.[97] According to Sutherland J:

> "[F]ixing on the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its true character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.
>
> * * *
>
> In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of the [statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. . . . To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[98]

Based on its purposive interpretation of the relevant legislation, therefore, the Court held that the transactions were properly characterised as a taxable dividend rather than a tax-free corporate reorganisation.

Following *Gregory v Helvering*, US courts developed broad judicial anti-avoidance doctrines in the form of a "business purpose test" and "substance over form doctrine". According to the former, tax benefits otherwise available under the relevant legislation could be denied to taxpayers who entered into transactions or relationships solely or primarily to obtain tax benefits not clearly intended by the legislation.[99] According to the latter, transactions should be characterised for tax purposes according to their commercial or economic substance rather than their legal form.[100] As a result, although the US Supreme Court in *Gregory v Helvering*, like the House of Lords in the *Duke of Westminster*, affirmed "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits,"[101] this right was not unfettered in the U.S, but subject to judicial anti-avoidance doctrines.

As with their approach to the structure and concept of income in the Canadian income tax, Canadian courts were quick to embrace the UK approach to the interpretation of tax statutes and the characterisation of transactions and relationships for tax purposes, rather than the purposive and substantive approach favoured by US courts. In a 1922 decision involving provincial tax legislation in Alberta, for example, the Supreme Court

97 *Gregory v Helvering* (1935) 293 US 465 at 470.

98 *Gregory v Helvering* (1935) 293 US 465 at 469.

99 See, e.g. *Bazley v Commission of Internal Revenue* (1947) 331 US 737; and *Goldstein v Commissioner of Internal Revenue* (1966) 364 F2d 734, 2d Cir., cert. denied (1967) 385 US 1005.

100 See, e.g. *Commissioner of Internal Revenue v Court Holding* (1945) 324 US 331; and *Waterman Steamship Corporation v Commissioner of Internal Revenue* (1970) 430 F2d 1185, 5th Cir., cert. denied (1971) 401 US 939.

101 *Gregory v Helvering* (1935) 293 US 465 at 469.

of Canada cited the House of Lords decision in *Tennant v Smith*[102] for the proposition that "[a] law imposing taxation should always be construed strictly against the taxing authorities since it restricts the public in the enjoyment of its property."[103] In a 1946 decision applying the IWTA, the Supreme Court of Canada cited the *Duke of Westminster* case for the proposition that "the true legal position" resulting from a contract "may not be ignored in favour of the supposed 'substance'" of the transaction.[104] In subsequent tax cases throughout the 1970s, Canadian courts consistently affirmed the doctrine that tax statutes should be construed strictly and literally,[105] and routinely cited the principle that tax should be assessed according to the true legal position of the parties irrespective of economic substance or the motivations of the parties.[106]

Not surprisingly, this judicial approach to the interpretation of tax statutes and to the characterisation of transactions and relationships for tax purposes had significant consequences for the development of Canadian income tax law. Since courts were generally unwilling to interpret statutory provisions in light of their purpose, legislative drafters developed a detailed and prolix writing style in order to prevent judicial misunderstanding—a process, as one Canadian commentator explains, that became "self-perpetuating" as detailed legislative provisions encouraged courts "to conclude that the treatment of the subject is exhaustive, and that the legislation is meant to say exactly what it says and does not mean to say anything that it omits."[107] Since courts were reluctant to include as income amounts that were not specifically identified in the statutory text, Parliament responded with regular amendments designed to "plug the gaps" created by restrictive judicial interpretations.[108] Since taxpayers could rely on the literal words of the statute and the legal form of transactions and relationships to plan their way around the rules of the statute,[109] Parliament introduced a multitude of specific anti-avoidance rules

102 *Tennant v Smith* [1892] AC 50 at 54, HL.

103 *Canadian Northern Railway Co v The Queen* (1922) 64 SCR 264 at [49], per Brodeur J.

104 *Dominion Telegraph Securities Ltd v MNR* (1946) [1947] SCR 45; [1946] CTC 239 (S.C.C.) at [19] per Kellock J. See also *Pioneer Laundry and Dry Cleaners Ltd. v MNR* [1939] 1 SCR 1; [1938-39] CTC 401, SCC at [10], per Davis J. (dissenting); and *Canada China Clay Ltd v Hepburn* [1945] CTC 91, SCC at [64]–[72], per Kellock J. (dissenting).

105 See, e.g. *The King v Crabbs* (1934), [1928–34] CTC 288, 1 DTC 272, SCC; *Worthington v A-G Manitoba* (1936), [1935–37] CTC 193, SCC; *The King v Montreal Telegraph Co* [1945] CTC 287, SCC; *MNR v Sheldon's Engineering Ltd* [1955] CTC 174, 55 DTC 1110, SCC; and *Malloney's Studio v The Queen* [1979] CTC 206; 79 DTC 5124, SCC.

106 See, e.g. *Army & Navy Department Store Ltd v MNR* [1953] CTC 293; 53 DTC 1185, SCC; *Front & Simcoe Ltd v MNR* [1960] CTC 123, 60 DTC 1081, Ex. Ct.; *Balstone Farms Ltd v MNR* [1966] CTC 738; 66 DTC 5482, Ex. Ct.; *Leveque v MNR* [1968] CTC 179; 68 DTC 5116, Ex. Ct.; *MNR v Cox* [1969] CTC 606; 69 DTC 5400, Ex. Ct.; *MNR v Ouellette* [1971] CTC 121; 71 DTC 5094, Ex. Ct.; and *MNR v Cameron* [1972] CTC 380; 72 DTC 6325, SCC.

107 S. Bowman, "Interpretation of Tax Legislation: The Evolution of Purposive Analysis" (1995) 43 *Canadian Tax Journal* 1167 at 1183.

108 See Bowman, fn.107 at 1184. Several examples of these amendments are discussed in the previous part of this article.

109 D. Sherbaniuk, "Tax Avoidance—Recent Developments" in *Report of the Proceedings of the Twenty-First Tax Conference* (Canadian Tax Foundation, Toronto, 1969) at 430, describing strict and literal construction of taxing statues and characterisation of transactions and relationships according to the legal position of the parties as the two "pillars of tax planning".

(SAARs) designed to limit these opportunities.[110] The result, as a prominent Canadian tax scholar wrote in 1969 (when the Canadian income tax was much shorter and less complicated than it is today!), is "a hopelessly complex, unmanageable labyrinth."[111]

As in the United Kingdom, Canadian courts began to question the traditional approach in the late 1970s and early 1980s. In 1976, the Federal Court of Appeal hinted at the development of a US-style business purpose test, concluding that personal services corporations that the taxpayers had incorporated primarily for tax reasons could be disregarded as shams on the basis that they lacked a *bona fide* business purpose.[112] In 1984, the Supreme Court of Canada formally rejected strict construction in *Stubart Investments Ltd v The Queen*,[113] affirming instead Professor Elmer Driedger's so-called "modern rule" according to which the words of an Act are to be read "in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament."[114] At the same time, however, the Court was reluctant to abandon the traditional approach to the characterisation of transactions and relationships, refusing to adopt a judicial business purpose test,[115] and declaring that taxpayers remained free to avail themselves of beneficial tax provisions once "contextually construed" provided that there was "no prohibition in the Act".[116]

Despite its reluctance in *Stubart Investments* to reject the legacy of legal formalism, subsequent Supreme Court of Canada tax decisions in the 1980s and early 1990s displayed a much greater willingness to question the characterisation of transactions and relationships according to their legal form. In *Johns-Manville Canada Inc v The Queen*,[117] for example, Estey J. stated on behalf of a unanimous panel of the Court that the distinction between a current expenditure (which is fully deductible in the year in which it is incurred) and a capital expenditure (the cost of which is generally deductible only over a number of years) should depend on "a commonsense appreciation of all the

110 See the summary of these rules in D.G. Duff, B. Alarie, K. Brooks, and L. Philipps, *Canadian Income Tax Law* (2nd ed., LexisNexis Butterworths, Toronto, 2006) at 183.

111 See Sherbaniuk, fn.109 at 435.

112 *MNR v Leon* [1976] CTC 532; 76 DTC 6299, FCA.

113 *Stubart Investments Ltd v The Queen* [1984] CTC 294; 84 DTC 6305, SCC.

114 E.A. Driedger, *Construction of Statutes* (2nd ed., Butterworths, Toronto, 1983) at 87, cited in *Stubart Investments* [1984] CTC 294; 84 DTC 6305, SCC at para.61. See also *Golden v The Queen* [1986] 1 CTC 274; 86 DTC 6138, SCC, in which a majority of the Court declared (at [10]) that: "In *Stubart* [. . .] the Court recognized that in the construction of taxation statutes the law is not confined to a literal and virtually meaningless interpretation of the Act where the words will support on a broader construction a conclusion which is workable and in harmony with the evident purposes of the Act in question. Strict construction in the historic sense no longer finds a place in the canons of interpretation applicable to taxation statutes."

115 *Stubart Investments Ltd v The Queen* [1984] CTC 294; 84 DTC 6305, SCC at [55], per Estey J. concluding that such a test would contradict Parliament's apparent intent to encourage specific activities through tax incentives. In a concurring judgment, Wilson J. rejected a business purpose test (at [71]–[72]) on the grounds that it would be "a complete rejection" of the *Duke of Westminster* principle that taxpayers may order their affairs to minimise tax, which was "far too deeply entrenched in our tax law for the courts to reject it in the absence of clear statutory authority."

116 *Stubart Investments Ltd v The Queen* [1984] CTC 294; 84 DTC 6305, SCC at [66], per Estey J.

117 *Johns-Manville Canada Inc v The Queen* [1985] 2 CTC 111; 85 DTC 5373, SCC.

guiding features" of the expenditure,[118] or "what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of legal rights. . .".[119] In *Imperial General Properties Ltd v The Queen*,[120] where the taxpayer was assessed on the grounds that it was "controlled" by and therefore "associated" with a family holding company that held 90 per cent of its common shares but only 50 per cent of its voting shares,[121] a majority of the Court dismissed the taxpayer's appeal on the basis that the holding company's ability to cause the taxpayer to be wound up on economically favourable terms gave it "[c]ontrol, in the real sense of the term,"[122] notwithstanding that it did not own a majority of the voting shares. According to the Court:

> "In determining the proper application of [the relevant statutory provision] to circumstances before a court, the court is not limited to a highly technical and narrow interpretation of the legal rights attached to the shares of a corporation. Neither is the court constrained to examine those rights in the context only of their immediate application in a corporate meeting."[123]

In each of these cases, therefore, the Court's more purposive approach to the interpretation of the ITA was complemented by a more substantive approach to the characterisation of transactions and relationships for tax purposes.

Although the decisions in *Johns-Manville* and *Imperial General Properties* demonstrated an increasing willingness on the part of the Supreme Court of Canada to characterise transactions and relationships in light of their commercial or economic reality, the high point of this substantive approach was its 1987 decision in *Bronfman Trust v The Queen*.[124] Disallowing the deduction of interest expenses on borrowed funds on the basis that the funds were used by the taxpayer to finance capital distributions to its sole beneficiary and not to earn income from business or property as required by the relevant statutory provision,[125] the Court explicitly affirmed a more substantive approach to the characterisation of transactions and relationships for tax purposes, welcoming a "recent

[118] *Johns-Manville Canada Inc v The Queen* [1985] 2 CTC 111; 85 DTC 5373, SCC at [41], citing the decision of the Privy Council in *B.P Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224 at 264, PC, per Lord Pearce.

[119] *Johns-Manville Canada Inc v The Queen* [1985] 2 CTC 111; 85 DTC 5373, SCC at [42], citing the decision of the Australian High Court in *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 at 648, Aust. H.C., per Dixon J.

[120] *Imperial General Properties Ltd v The Queen* [1985] 2 CTC 299; 85 DTC 5500, SCC.

[121] The effect of this assessment was that the taxpayer corporation and the holding company were required the share the amount eligible for a low rate of corporate tax under the "small business deduction" in ITA, s.125.

[122] *Imperial General Properties Ltd v The Queen* [1985] 2 CTC 299; 85 DTC 5500, SCC at [14].

[123] *Imperial General Properties Ltd v The Queen* [1985] 2 CTC 299; 85 DTC 5500, SCC at [11], per Estey J.

[124] *Bronfman Trust v The Queen* [1987] 1 CTC 117; 87 DTC 5059, SCC. For detailed discussions of this case, see D.G. Duff, "Interpreting the *Income Tax Act*—Part 1: Interpretive Doctrines" (1999) 47 *Canadian Tax Journal* 464 at 489; and D.G. Duff, "Interest Deductibility, the Reasonable Expectation of Profit Test and the Supreme Court of Canada: From *Bronfman Trust* and *Moldowan* to *Singleton, Ludmer*, *Stewart* and *Walls*," in *Advocacy and Taxation in Canada* (David W. Chodikoff and James L. Horvath (eds), Irwin Law, Toronto, 2004) 399 at 402.

[125] ITA, subpara.20(1)(c)(i).

trend in tax cases towards attempting to ascertain the true commercial and practical nature of the taxpayer's transactions,"[126] and declaring that:

> "Assessment of taxpayers' transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon the taxpayer's sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction."[127]

As the Supreme Court of Canada's decision in *Stubart Investments* rejected the legacy of strict and literal interpretation, therefore, its decision in *Bronfman Trust* rejected the legacy of legal formalism. Three years later, in *McClurg v The Queen*,[128] the Supreme Court of Canada reaffirmed its break from the traditional judicial approach to tax statutes, explaining that courts should "determine both the purpose of the legislative provision and the economic and commercial reality of the taxpayer's actions."[129]

Notwithstanding these judicial developments, however, the federal government concluded in 1987 that existing rules were "inadequate to deal with a number of blatant tax avoidance arrangements" and that it should enact a statutory general anti-avoidance rule (GAAR) "to prevent artificial tax avoidance arrangements" and to reduce what the Supreme Court of Canada decision in *Stubart Investments* had described as the:

> ". . . action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally-guided and equally specialized taxpayer reaction."[130]

As subsequently enacted, this provision allows the revenue authorities to determine a person's tax consequences "as is reasonable in the circumstances in order to deny a tax benefit" whenever the tax benefit results from a transaction or series of transactions of which the transaction is a part, the transaction may reasonably be considered to have been undertaken or arranged primarily to obtain the tax benefit, and the transaction may reasonably be considered to result in a misuse of specific provisions of the ITA or an abuse having regard to these provisions read as a whole.[131] As the GAAR generally applies only to transactions entered into on or after September 13, 1988, however, it was not until 2005 that the Supreme Court of Canada first considered this provision.[132]

126 *Bronfman Trust v The Queen* [1987] 1 CTC 117; 87 DTC 5059, SCC at [48].

127 *Bronfman Trust v The Queen* [1987] 1 CTC 117; 87 DTC 5059, SCC at [49].

128 *Bronfman Trust v The Queen* [1991] 1 CTC 169; 91 DTC 5001, SCC. For a detailed discussion of this case, see Duff (1999), fn.124 at 494–501.

129 *McClurg v The Queen* [1991] 1 CTC 169; 91 DTC 5001, SCC at [46].

130 Canada, Department of Finance, *The White Paper: Tax Reform 1987* (Department of Finance, Ottawa, June 18, 1987), reproduced in *White Paper on Tax Reform* (CCH, Don Mills, ON, 1987) 23 at 70, citing *Stubart Investments*, [1984] CTC 294; 84 DTC 6305, SCC at [67].

131 ITA, s.245. In order to reverse two Tax Court of Canada decisions questioning whether the GAAR would apply to the misuse or abuse of other relevant enactments such as regulations or tax treaties, the provision was amended in 2005 to mention these other enactments as well.

132 *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC; and *Mathew v The Queen* [2005] 5 CTC 244; 2005 DTC 5538, SCC. For detailed discussions of these decisions, see D.G. Duff, "The Supreme Court of Canada and the General Anti-Avoidance Rule: *Canada Trustco* and *Mathew*" (2006) 60 BFIT 54; J. Li, "Economic Substance: Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) 54 *Canadian Tax Journal* 23; and B.J. Arnold,

While one might have thought that enactment of a statutory GAAR would have sent a strong signal to Canadian courts to employ a purposive interpretative approach and a substantive approach to the characterisation of transactions and relationships for tax purposes, irrespective of the provision's actual application to the facts of any particular case, the introduction of this statutory provision appears to have had the opposite effect.[133] In contrast to the purposive and substantive approach to tax statutes that the Supreme Court of Canada adopted in the 1980s and early 1990s, the Court's tax jurisprudence from the mid-1990s to the early 2000s saw a return to kind of the textual interpretation and legal formalism that characterized the traditional judicial approach to tax statutes.[134]

The first indication of this judicial reaction was the Supreme Court of Canada's 1994 decision in *Antosko v The Queen*.[135] Rejecting the Minister's argument that the taxpayers should not be entitled to a deduction that was not intended by the applicable statutory provision and would result in an unanticipated windfall, the Court relied on a "straightforward grammatical reading" of the provision to allow the taxpayers' appeal.[136] More importantly, the Court stated:

> "While it is true that the courts must view discrete sections of the *Income Tax Act* in light of the other provisions of the Act and of the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality, such techniques cannot alter the result where the words of the statute are clear and plain and where the practical effect of the transaction is undisputed.
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> * * *

"Confusion Worse Confounded—The Supreme Court's GAAR Decisions" (2006) 54 *Canadian Tax Journal* 167. For more general discussions of the impact of the cases on tax avoidance in Canada, see B. Alarie, S. Bhatia, and D.G. Duff, "Symposium on Tax Avoidance After *Canada Trustco* and *Mathew*: Summary of Proceedings" (2005) 53 *Canadian Tax Journal* 1010; and D.G. Duff and H. Erlichman (eds), *Tax Avoidance in Canada after Canada Trustco and Mathew* (Irwin Law, Toronto, 2007).

133 See D.G. Duff, "Justice Iacobucci and the 'Golden and Straight Metwand' of Canadian Tax Law" (2007) 57 *University of Toronto Law Journal* 525 at 576, suggesting that the leading tax judge on the Supreme Court of Canada during the 1990s took the view that the enactment of a statutory GAAR meant that this provision, rather than judicial action should be relied upon to prevent unacceptable tax avoidance.

134 The explanation for this shift has much to do with key personalities on the Supreme Court of Canada, who were able to shape its tax jurisprudence during their tenure. From the late 1970s to the early 1990s, the Court's purposive and substantive approach was championed by Dickson J. who became Chief Justice in April 1984 and retired from the bench in June 1990, and by Estey J. who retired in April 1988. From the mid-1990s to the early 2000s, the literal and formalist approach was advanced by Justice Iacobucci who was appointed to the Court in January 1991 and retired in June 2004, Major J. who was appointed to the Court in November 1992 and retired in December 2005, and McLachlin J. who was appointed to the Court in March 1989 and became Chief Justice in January 2000. For a detailed account of Iacobucci J.'s influence on the transformation of Canadian income tax law in the 1990s and early 2000s, see Duff, fn.133 at 541.

135 *Antosko v The Queen* [1994] 2 CTC 25; 94 DTC 6314, SCC. For detailed discussions of this decision, see Duff, (1999) fn.124 at 507; and Duff, fn.133 at 542.

136 *Antosko v The Queen* [1994] 2 CTC 25; 94 DTC 6314, SCC at [46].

> Where the words of the section are not ambiguous, it is not for this Court to find that the appellants should be disentitled to a deduction because they do not deserve a 'windfall', as the respondent contends."[137]

As the transactions at issue adhered to the "plain meaning" of the statutory provision,[138] the Court concluded, the taxpayers were entitled to the deduction.

The next year, the Supreme Court of Canada reaffirmed this "plain meaning" approach in *Friesen v The Queen*,[139] in which a majority of the Court allowed the taxpayer to utilise a statutory "lower of cost or market value" rule to recognise an accrued loss on a single item of vacant land that the taxpayer acquired as an adventure or concern in the nature of trade on the basis that this result was authorised by a "plain reading" of the relevant statutory provisions.[140] Describing the "plain meaning rule" as the "correct approach" to the interpretation of tax legislation in Canada,[141] the judgment also accepted the following statement from a treatise on Canadian income tax law:

> "When a provision is couched in specific language that admits of no doubt or ambiguity in its application to the facts, then the provision must be applied regardless of its object and purpose. Only when the statutory language admits of some doubt or ambiguity in its application to the facts is it useful to resort to the object and purpose of the provision."[142]

By the mid-1990s, therefore, a majority of the Supreme Court of Canada had rejected purposive interpretation in favour of a more literal interpretive approach reminiscent of pre-*Stubart Investments* tax jurisprudence.[143]

In subsequent years, the Supreme Court of Canada combined this renewed emphasis on textual interpretation with a return to the formalist approach that preceded its decisions in *Johns-Manville*,[144] *Imperial General Properties*,[145] and *Bronfman Trust*.[146] In *Shell Canada*

137 *Antosko v The Queen* [1994] 2 CTC 25; 94 DTC 6314, SCC at [29] and [38], per Iacobucci J.

138 *Antosko v The Queen* [1994] 2 CTC 25; 94 DTC 6314, SCC at [41].

139 *Friesen v The Queen* [1995] 3 SCR 103, SCC. For a detailed discussion of this decision, see Duff (1999), fn.124 at 511.

140 *Friesen v The Queen* [1995] 3 SCR 103, SCC at [71]. For a critical assessment of this assumed "plain meaning" see Duff (1999), fn.124 at 515, arguing that because the relevant statutory provision allowing inventory to be valued at the lower of its cost or fair market value applied only "[f]or the purpose of computing income from a business," a taxpayer with a single item of inventory held in an adventure in the nature of trade should not have been able to access the rule to trigger a loss for tax purposes because there was no reason to compute the taxpayer's income or loss from the business until the inventory was sold.

141 *Friesen v The Queen* [1995] 3 SCR 103, SCC at [10], per Major J.

142 *Friesen v The Queen* [1995] 3 SCR 103, SCC at [11], citing P.W. Hogg and J.E. Magee, *Principles of Canadian Income Tax Law* (Carswell, Scarborough, Ontario, 1995) at 453.

143 Curiously, this is despite the Court's affirmation during the very same year of a "teleological approach" to the interpretation of tax statutes, according to which a court should "first . . . determine the purpose of the legislation, whether as a whole or as expressed in a particular provision" and construe the provision at issue according to "the purpose underlying it." *Corporation Notre-Dame de Bon-Secours v Québec* [1994] 1 CTC 241 at 250 and 252, 95 DTC 5017, SCC, per Gonthier J.

144 *Johns-Manville Canada Inc v The Queen* [1985] 2 CTC 111; 85 DTC 5373, SCC.

145 *Imperial General Properties Ltd v The Queen* [1985] 2 CTC 299; 85 DTC 5500, SCC.

146 *Bronfman Trust v The Queen* [1987] 1 CTC 117; 87 DTC 5059, SCC.

v The Queen,[147] for example, where the taxpayer engaged in a classic "tax arbitrage" transaction designed to generate fully deductible interest expenses on a weak currency loan and a partly taxable foreign exchange gain when the debt was subsequently repaid,[148] the Court refused to disallow or limit the taxpayer's deduction of interest expenses on the basis that "absent a provision of the Act to the contrary or a finding that they are a sham, a taxpayer's legal relationships must be respected in tax cases."[149] Similarly in *Singleton v The Queen*,[150] where the taxpayer contributed borrowed funds to a legal partnership from which he simultaneously withdrew funds to purchase a house, the Court permitted the deduction of interest expenses on the borrowed funds on the grounds that courts must not "search for the economic realities" of the transactions,[151] but should instead assess each transaction independently "[i]n order to give effect to the legal relationships" that they created.[152] In *Ludmer v MNR*,[153] which involved another tax arbitrage transaction designed to obtain fully deductible interest expenses and a subsequent partly taxable capital gain, the Court again refused to disallow or limit the deduction of interest expenses on the grounds, among others, that courts should not interpret provisions of the ITA to prevent tax avoidance "when it is open to Parliament to be precise and specific with respect to any mischief to be prevented," and that "[t]o do otherwise would be to fail to give appropriate weight to the well-established principle that, absent a provision to the contrary, taxpayers are entitled to arrange their affairs for the sole purpose of achieving a favourable position regarding taxation."[154]

Not surprisingly, as occurred prior to the Supreme Court of Canada's more purposive and substantive approach in the 1980s and early 1990s, the federal government responded to several of these decisions with specific amendments designed to clarify the statutory scheme and limit further opportunities for avoidance. In response to *Friesen*,[155] for example, the ITA was amended to exclude adventures or concerns in the nature of trade from the statutory lower of cost or market value rule,[156] and to specify that inventory held as an adventure or concern in the nature of trade must be valued at cost (thereby

[147] *Shell Canada v The Queen* [1999] 4 CTC 313; 99 DTC 5669, SCC. For a critical examination of this decision, see D.G. Duff, "Weak Currency Borrowings and the General Anti-Avoidance Rule in Canada: From *Shell Canada* to *Canadian Pacific*" (2001) 55 BFID 233 at 234.

[148] For a useful definition of "tax arbitrage" see D.N. Shaviro, "The Story of *Knetsch*: Judicial Doctrines Combating Tax Avoidance" in Caron (ed.), fn.25, 313 at 315, explaining that tax arbitrage, like arbitrage in financial or other markets, results from price differentials (in the case of tax arbitrage, differences in the tax treatment of revenues and expenditures) that enable the arbitrageur (or taxpayer, in the case of tax arbitrage) to profit from these differences without incurring significant transactions costs.

[149] *Shell Canada v The Queen* [1999] 4 CTC 313; 99 DTC 5669, SCC at [39], per McLachlin J. (as she then was).

[150] *Singleton v The Queen* [2002] 1 CTC 121, 2001 DTC 5533, SCC. For a detailed discussion of this decision, see Duff (2004), fn.124 at 409.

[151] *Singleton v The Queen* [2002] 1 CTC 121; 2001 DTC 5533, SCC at [31].

[152] *Singleton v The Queen* [2002] 1 CTC 121; 2001 DTC 5533, SCC at [34], per Major J.

[153] *Ludmer v MNR* [2002] 1 CTC 95, 2001 DTC 5505, SCC. For detailed discussions of this decision, see Duff (2004), fn.124 at 411–16; and Duff, fn.133 at 556.

[154] *Ludmer v MNR* [2002] 1 CTC 95, 2001 DTC 5505, SCC at [39] per Iacobucci J.

[155] [1995] 2 CTC 369; 95 DTC 5551, SCC.

[156] ITA, s.10(1), amended by S.C. 1998, c. 19, s.70(1), applicable to taxation years ending after December 20, 1995.

preventing the recognition of accrued but unrealized losses in the value of the inventory).[157] In response to *Shell Canada*,[158] Parliament enacted a lengthy and complicated specific anti-avoidance rule designed to eliminate the tax advantages otherwise available from weak currency borrowings.[159] In response to *Ludmer*[160] and other Supreme Court of Canada decisions allowing the deduction of interest expenses on borrowed money used to acquire property designed to produce a deferred partly taxable capital gain,[161] the Department of Finance introduced draft legislation establishing a statutory "reasonable expectation of profit" test, disallowing the deduction of a business or property loss where it is not:

> ". . . reasonable to expect that the taxpayer will realize a cumulative profit from that business or property for the period in which the taxpayer has carried on, and can reasonably be expected to carry on, that business or has held, and can reasonably be expected to hold, that property."[162]

More than four years after it was introduced, this draft legislation remains un-enacted, as a result of which taxpayers can still engage in various kinds of tax arbitrage transactions in Canada—subject, that is, to the potential application of the statutory GAAR.

Returning to the GAAR, finally, the legacy of strict and literal interpretation and formalist characterisation appears to have endured even in the interpretation of this provision, which was enacted in order to supplant this traditional approach. Although the first Supreme Court of Canada decisions to consider the GAAR signalled a return to a more contextual and purposive approach to the interpretation of tax statutes—emphasising that the GAAR and other provisions of the ITA "must be interpreted in a textual, contextual and purposive way"[163]—the Court also observed that the ITA is "dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation."[164] As a result, although other recent Supreme Court of Canada decisions also suggest a

157 ITA, s.10(1.01), added by S.C. 1998, c. 19, s.70(1), applicable to taxation years ending after December 20, 1995.

158 [1999] 4 CTC 313, 99 DTC 5669, SCC.

159 ITA, s.20.3, added by S.C. 2001, c. 17, s. 14(1), applicable to taxation years ending after February 27, 2000.

160 *Ludmer v MNR* [2002] 1 CTC 95 ; 2001 DTC 5505, SCC.

161 *Stewart v The Queen* [2002] 3 CTC 439; 2002 DTC 6969, SCC; and *The Queen v Walls* [2002] 3 CTC 421; 2002 DTC 6960, SCC. For a detailed discussion of these decisions and the judicial "reasonable expectation of profit" test that they rejected, see Duff (2004), fn.124 at 416–27. See also the discussion of *Stewart* in Duff, fn.133 at 562.

162 Proposed ITA, s.3.1(1), released October 31, 2003.

163 *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC at [11]. According to the Court (at [10]): "The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole."

164 *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC at [13]. Lest this approach be misconstrued as a version of the "plain meaning rule", however, the Court was careful to note that "statutory context and purpose may reveal or resolve latent ambiguities" even in circumstances where "the meaning of particular provisions may not appear ambiguous at first glance"—emphasising that "language can never be interpreted independently of its context, and legislative purpose is part of context." *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC at [47], citing P.W. Hogg, J. Magee, and J. Li, *Principles of Canadian Income Tax Law* (4th ed., Carswell, Scarborough, 2002) at 563.

more purposive approach to the interpretation of tax legislation,[165] the legacy of strict and literal interpretation endures in a largely textual approach to the interpretation of detailed legislative provisions that were drafted in light of strict and literal interpretation.[166]

More significantly, the Court's reading of the GAAR suggests a continuing reluctance to abandon the traditional emphasis that UK and Canadian courts have placed on the legal substance of transactions and relationships, irrespective of their economic substance or the motivations of the parties. Explaining that the GAAR "does not permit the 'recharacterization' of a transaction for the purposes of determining whether or not it is an avoidance transaction",[167] the Court concluded that courts must "examine the relationships between the parties and the actual transactions that were executed between them" in order to decide whether the GAAR applies,[168] and may not conclude that an avoidance transaction is abusive solely because it lacks economic substance.[169] More generally, the Court declared, although the GAAR may have weakened the *Duke of Westminster* principle,[170] this traditional approach endures despite the "superimposition" of a prohibition on abusive tax avoidance.[171] As a result, it seems, the formalist approach continues to persist despite the introduction of a statutory GAAR. Whether this approach will continue as the Supreme Court of Canada considers future GAAR cases remains to be determined.[172]

[165] See *Placer Dome Canada Ltd v The Queen* [2006] 1 SCR 715; *Imperial Oil Ltd v The Queen* [2006] 2 SCR 447; and *A. Y.S.A. Amateur Youth Soccer Association v Canada* [2006] 1 SCR 715.

[166] For this reason, the vitality of more purposive approaches to the interpretation of tax statutes may depend on more principles-based approaches to the drafting of tax legislation. For suggestions along these lines, see J.F. Avery Jones, "Tax Law: Rules or Principles?" [1996] BTR 580; D. Weisbach, "Formalism in the Tax Law" (1999) 66 *University of Chicago Law Review* 860; and J. Braithwaite, "Making Tax Law More Certain: A Theory" Australian National University Centre for Tax System Integrity, Working Paper No. 44 (December 2002), currently available at: *http://ctsi.anu.edu.au/publications/WP/44.pdf* (accessed May 1, 2008); and S. Picciotto, "Constructing Compliance: Game-playing, Tax Law and the Regulatory State" (2007) 29 *Law & Pol.* 11. For a discussion of principles-based drafting in the Australian context, see G. Pinder, *The Coherent Principles Approach to Tax Law Design*, currently available at: *www.treasury.gov.au/documents/987/PDF/07_coherent_principles.pdf* (accessed May 1, 2008).

[167] *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC at [29], citing Hon. Michael H. Wilson, Minister of Finance, Explanatory Notes to Legislation Relating to Income Tax (June 1988) at 464.

[168] *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC at [30].

[169] *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC at [57], suggesting (at [58]) that this consideration is relevant only where the object, spirit and purpose of the statutory provisions at issue specifically limit tax benefits to transactions with economic substance. For critical assessments of this conclusion, see Duff (2006), fn.132 at 67; and Li, fn.132 at 35.

[170] *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC at [13], stating that "the *Duke of Westminster* principle and the emphasis on textual interpretation may be attenuated."

[171] *Canada Trustco Mortgage Co v The Queen* [2005] 5 CTC 215; 2005 DTC 5523, SCC at [1], declaring that the ITA "continues to permit legitimate tax minimization" and that the task of the courts is "to unite" the traditional approach with the GAAR in a manner that achieves "consistent, predictable and fair results."

[172] At the time of writing, the Supreme Court of Canada had just granted leave to appeal in another GAAR case, involving the deduction of interest expenses on borrowed funds used by one spouse to purchase shares from the other spouse, who used the proceeds from the sale of the shares to purchase a home. *Lipson v Canada*, 2007 FCA 113; leave to appeal granted by the Supreme Court of Canada, [2007] SCCA No. 248. The appeal was heard on April 23, 2008 and the Court reserved its judgment.

Conclusion

UK tax concepts have exerted ongoing influence in the development of Canadian income tax law. This influence extends not only to the prevailing concept of income in Canadian income tax, but also, crucially, to judicial approaches to the interpretation of tax statutes and tax avoidance. With respect to the concept of income, Canadian courts have been influenced by UK source and trust concepts of income as well as the schedular nature of the UK income tax. These influences have effectively disinclined Canadian judicial decisions—with some rare exceptions, such as the Supreme Court of Canada's decision in *Curran* in 1959—from taking seriously a global or accretion concept of income for the purposes of the Canadian income tax. In response to judicial decisions adopting a narrower view of income under the influence of these UK tax concepts, the Canadian income tax has often been amended to extend the breadth of the tax. These amendments, like the judicial decisions they have displaced, as well as subsequent judicial decisions in which they have been considered, remain as an enduring legacy of UK tax concepts in Canadian income tax law.

With respect to interpretation and tax avoidance, Canadian courts originally adopted the strict and literal approach that UK courts embraced from the mid-nineteenth century to the 1970s as well as the formalist approach to the characterisation of transactions and legal relationships that the House of Lords adopted in the *Duke of Westminster* case. Although Canadian courts began to depart from this approach in the 1980s—with the Supreme Court of Canada rejecting strict and literal interpretation in its 1984 decision in *Stubart Investments*,[173] and embracing a more substantive approach to the characterisation of transactions and relationships for tax purposes in its 1987 decision in *Bronfman Trust*[174]—the legacy of strict and literal interpretation and formalistic characterisation endures in the detailed and prolix manner in which income tax legislation is drafted, the multitude of provisions designed to fill gaps created by restrictive judicial interpretations, the variety of specific anti-avoidance rules (SAARs) designed to limit opportunities, and the existence of a statutory general-anti avoidance rule (GAAR) enacted in 1988. Despite the Supreme Court of Canada's emphasis during the 1980s and early 1990s on purposive interpretation and substantive characterisation, moreover, the traditional judicial approach resurfaced from the mid-1990s to the early 2000s as the Supreme Court of Canada adopted a more literal interpretative approach and a more formalist approach to the characterisation of transactions and relationships for tax purposes. While more recent Supreme Court of Canada decisions suggest a greater willingness to interpret tax provisions in light of their context and purpose, the traditional approach endures in a continuing emphasis on textual interpretation of tax legislation and in a formalist approach to the application of the GAAR that seeks to "unite" the traditional *Duke of Westminster* principle with the very different approach intended by the GAAR. LT

[173] *Stubart Investments Ltd v The Queen* [1984] CTC 294; 84 DTC 6305, SCC.

[174] *Bronfman Trust v The Queen* [1987] 1 CTC 117; 87 DTC 5059, SCC.

LT Canada; Comparative law; Income; Income tax; Legal history; Statutory interpretation; Tax avoidance