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Legislated Interpretation and Tax Avoidance in Canadian Income Tax Law

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1. Introduction

Predictable statutory interpretation helps ensure the reliable operation of contemporary systems of taxation. Tax liabilities that are not clearly expressed and articulated by legislatures lead to over-reliance on litigation as a means to enforce and clarify legislative intent. For this reason, modern legislatures continually amend and draft new tax provisions, reformulating existing rules and introducing new ones to address ever-changing social and economic environments. Moreover, legislatures also respond with amendments directed at judicial decisions with which they disagree, as well as the transactions and arrangements at issue in these cases. As these amended and new rules are then subject to application and interpretation by revenue departments, taxpayers, tax advisors, and the courts, all of which legislatures may respond to through further subsequent amendments, tax legislation at any given time can be regarded as the recursive product of an ongoing dialogue.

At the same time, the proliferation of ever-more detailed provisions in tax legislation greatly increases the complexity of these statutes. The consequent tendency toward textual interpretation of tax legislation can facilitate tax avoidance that undermines the capacity of a tax system to raise revenue in a manner that is fair or equitable. For this reason, tax statutes like the Canadian *Income Tax Act* (*ITA*)[1] typically combine detailed statutory provisions with more broadly-worded anti-avoidance rules that deny unintended tax advantages that might otherwise result from other statutory provisions. At the apex of these anti-avoidance rules stand general anti-avoidance rules (GAARs) like section 245 of the *ITA*. Section 245 denies tax benefits resulting from tax-motivated transactions that result in a misuse of other provisions of the *ITA* or other relevant enactments, or an abuse having regard to these provisions read as a whole.

In order to "legislate" statutory interpretation, therefore, legislatures generally employ two different approaches: enacting detailed rules in response to changing circumstances and judicial decisions, while simultaneously directing courts to prevent abusive tax avoidance by applying more generalized standards that require them to go beyond or behind the text of the tax legislation in order to deny tax benefits claimed by taxpayers that conflict with the object, spirit or purpose of these provisions. As this paper explains, judicial experience in Canada demonstrates a tension between these two approaches, since the existence of detailed statutory rules can make courts reluctant to apply a general anti-avoidance rule that requires them to depart from the statutory text.

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[1] R.S.C. 1985, Chapter 1 (5th Supp.) [ITA].

This paper considers the GAAR in section 245 of the *ITA* as an example of legislated statutory interpretation, explaining the origins and structure of this provision and the extent to which it has shaped the interpretation of Canadian income tax law. Part II provides a background to the GAAR, contrasting the textual and formalist approach to tax statutes that was traditionally adopted by English and Canadian courts with the more purposive and substantive approach adopted by U.S. courts as well as English and Canadian courts in the 1980s and early 1990s. Part III explains the basic structure of the GAAR and the way in which Canadian courts have interpreted key elements of this provision. Part IV reviews key tax avoidance cases after the GAAR was introduced, illustrating a lingering affect of pre-GAAR interpretive approaches in the post-GAAR world, from which the courts have only begun to depart. Part V concludes.

2. Background

Judicial approaches to the application of tax statutes involve two interconnected aspects: interpretation of the relevant statutory text, and characterization of the transactions and relationships to which the statute applies.[2] 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 interpretive approaches are apt to characterize transactions without regard to taxpayer motivations, while purposive approaches are more likely to characterize or re-characterize transactions in light of the statutory scheme. As background to the GAAR and its impact on the interpretation of tax statutes in Canada, the following sections review traditional Anglo-Canadian and American judicial approaches to tax statutes, and departures from the traditional Anglo-Canadian approach in the 1970s and 1980s.[3]

(a) Traditional Anglo-Canadian and American Approaches to Tax Statutes

Following early U.K. tax decisions, Canadian courts originally adopted a narrow approach to tax legislation, interpreting tax statutes in a strict and literal manner and resolving any ambiguities taxing provisions in favour of the taxpayer. In his judgment in the House of Lords 1869 decision in *Partington v. Attorney-General*,[4] for example, Lord Cairns declared that "the principle of all fiscal legislation" was that:

> [I]f the subject 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. In other words, if there be admissible, in any statute, what is called equitable construction, certainly such a

[2] See David G. Duff, Benjamin Alarie, Kim Brooks, and Lisa Philipps, *Canadian Income Tax Law*, 5th ed., (Toronto: LexisNexis Butterworths, 2015), chapters 2 and 3.
[3] These sections are based on David G. Duff, "Justice Iacobucci and the 'Golden and Straight Metwand' of Canadian Tax Law" (2007), 57 *U.T.L.J.* 525 at 527-541.
[4] (1869), L.R. 4 H.L. 100

> construction is not admissible in a taxing statute where you simply adhere to the words of the statute.[5]

A little more than 20 years later, Lord Halsbury expressed a similar view in *Tennant v. Smith*,[6] stating that:

> In a taxing Act it is impossible, I believe, to assume any intention, any governing purpose in the Act, to do more than take such tax as the statute imposes…. [I]nasmuch as you have no right to assume that there is any governing object which a taxing Act is intended to attain other than that which it has expressed by making such and such objects the intended subjects of taxation, you must see whether a tax is expressly imposed.[7]

In 1922, the Supreme Court of Canada affirmed the same approach, stating 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."[8]

Together with this strict approach to the interpretation of tax statutes, English and Canadian courts also adopted an approach to the characterization of transactions that assessed tax consequences according to the legal form of transactions and relationships notwithstanding that they may have been entered into primarily or solely in order to minimize taxes otherwise payable. In the leading English case of *Commissioner of Inland Revenue v. Duke of Westminster*,[9] for example, where the Duke of Westminster had deliberately entered into an arrangement with his gardener to convert otherwise non-deductible remuneration into deductible payments, a majority of the House of Lords upheld the Duke's appeal against an assessment characterizing the payments as non-deductible remuneration on the grounds that the legal documents confirming the arrangement explicitly provided that the payments were not remuneration and that the gardener was not prevented from "being entitled to and claiming full remuneration for such further work as you may do" – though the document also stated 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."[10]

Rejecting the Commissioner's 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,"[11] and rejected 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 streight metwand

[5] *Ibid*. at 128.
[6] [1892] A.C. 50 (H.L.).
[7] *Ibid*. at 154.
[8] *Canadian Northern Railway. Co. v. R.* (1922), 64 S.C.R. 264 [*Canadian Northern Railway*] at 275, *per* Brodeur J.
[9] [1936] A.C. 1 (H.L.).
[10] *Ibid*. at 11-12.
[11] *Ibid*. at 20.

of the law.'"[12] Concurring, Lord Russell of Killowen drew a clear connection between the characterization of transactions and relationships for tax purposes and the interpretation of tax statutes, criticizing "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."[13]

In contrast to this Anglo-Canadian approach, U.S. courts adopted a more purposive approach to the interpretation of tax legislation and a correspondingly more substantive approach to the characterization of tax-motivated transactions that contradict the scheme or purpose of the relevant legislation. In the leading American case of *Gregory v. Helvering*,[14] for example, where the taxpayer engaged in a tax-motivated corporate reorganization intended to distribute to herself publicly-traded shares held by a private holding company without incurring any tax on the distribution, the U.S. Supreme Court upheld an assessment characterizing the reorganization as a taxable dividend on the basis that the transactions were "outside the plain intent of the statute" notwithstanding that they adhered to the text of the statutory definition for a tax-free reorganization.[15] Based on its purposive interpretation, therefore, the Court held that the transactions were properly characterized as a taxable dividend rather than a tax-free corporate reorganization.

Not surprisingly, as the *Duke of Westminster* case itself illustrates, the Anglo-Canadian emphasis on literal interpretation of tax statutes and characterization of transactions and relationships according to their legal form was highly conducive to tax avoidance.[16] Although English and Canadian courts were prepared to disregard "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,"[17] they would not re-characterize transactions like those in the *Duke of Westminster* case that created real legal rights and obligations – even if these were undertaken solely or primarily to avoid tax and were contrary to the object or purpose of the relevant legislation. Instead, they consistently affirmed Lord Tomlin's statement in in the *Duke of Westminster* case that:

> 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 unappreciated the Commissioners

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[12] *Ibid*. at 19.
[13] *Ibid*. at 24.
[14] 293 US 465 (1935) [*Gregory*].
[15] *Ibid*. at 470.
[16] See, e.g., Douglas J. Sherbaniuk, "Tax Avoidance – Recent Developments, in *Report of the Proceedings of the Twenty-First Tax Conference*, 1968 Conference Report (Toronto: Canadian Tax Foundation, 1969) 430-42 at 430-32 (describing literalism and formalism as the two "pillars of tax planning").
[17] *Snook v. London & West Riding Investments Ltd.*, [1967] 1 All E.R. 518 at 528 (C.A.), *per* Lord Diplock. This definition of a "sham" was approved by the Supreme Court of Canada in *M.N.R. v. Cameron*, [1972] C.T.C. 380, 72 D.T.C. 6325 (S.C.C.).

of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[18]

The Anglo-Canadian approach to tax interpretation also 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 drafting 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."[19] 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.[20] As well, 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, Parliament introduced a multitude of specific anti-avoidance rules (SAARs) designed to limit these opportunities.[21] The result, as a prominent Canadian tax scholar wrote in 1969, is "a hopelessly complex, unmanageable labyrinth"[22] – a problem that is, of course, more acute today, with the ensuing 50 years of amendments and elaboration.

In marked contrast to the Anglo-Canadian approach, U.S. courts relied on the reasons in *Gregory* decision to develop 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.[23] According to the latter, transactions should be characterized for tax purposes according to their commercial or economic substance rather than their legal form.[24] As a result, although the judgment of the U.S. Supreme Court in *Gregory* had, like the judgment of the House of Lords in the *Duke of Westminster* case, 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,"[25] this right was not unfettered, but subject to significant judicial constraints.

(b) Departures from the Traditional Anglo-Canadian Approach in the 1970s and 1980s

Despite their initial adherence to the principles established in the *Duke of Westminster* case, English and Canadian courts began to depart from this approach in the late 1970s and early

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[18] *Duke of Westminster*, *supra* note 9 at 19-20.
[19] Stephen Bowman, "Interpretation of Tax Legislation: The Evolution of Purposive Analysis" (1995), 43 *Canadian Tax Journal* 1167 at 1183-84.
[20] *Ibid*. at 1184.
[21] See the brief summary of some of these rules in Duff et al., *supra* note 2 at 173-80.
[22] Sherbaniuk, *supra* note 16 at 435.
[23] See, e.g., *Bazley v. Commission of Internal Revenue*, 331 US 737 (1947); and *Goldstein v. Commissioner of Internal Revenue*, 364 F2d 734 (2d Cir. 1966), cert. denied 385 US 1005 (1967).
[24] See, e.g., *Commissioner of Internal Revenue v. Court Holding*, 324 US 331 (1945); and *Waterman Steamship Corporation v. Commissioner of Internal Revenue*, 430 F2d 1185 (5th Cir. 1970), cert. denied 401 US 939 (1971).
[25] *Gregory*, *supra* note 14 at 469.

1980s. In 1976, for example, the Federal Court of Appeal hinted at the development of a American-style business purpose test, concluding that personal services corporations that taxpayers had incorporated primarily for tax reasons could be disregarded as shams on the basis that they lacked a *bona fide* business purpose.[26] In a trilogy of decisions in the early 1980s, the English House of Lords developed a so-called "step-transactions doctrine" according to which they could disregard purely tax-motivated transactions inserted into a preordained series of transactions.[27]

In 1984, the Supreme Court of Canada formally rejected strict construction in *Stubart Investments Ltd. v. The Queen*,[28] 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."[29] Two years later, in *Golden v. The Queen*,[30] the Court reaffirmed this conclusion, stating 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 ….[31]

Notwithstanding this rejection of strict construction, the Supreme Court of Canada was unwilling to abandon the traditional Anglo-Canadian emphasis on the legal character of transactions and relationships regardless of whether they were entered into primarily or solely to minimize taxes otherwise payable. Although acknowledging that "the taxpayer's freedom to carry on his commercial and social affairs however he may choose" must be balanced against "the state interest in revenue, equity in the raising of revenue, and economic planning,"[32] the Court rejected the Minister's argument that a tax-motivated series of transactions could be ignored solely because it lacked "a valid business purpose"[33] on the grounds that this would contradict Parliament's apparent intent to use tax incentives to encourage specific activities.[34] At

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[26] *Minister of National Revenue v. Leon*, [1976] C.T.C. 532, 76 D.T.C. 6299 (F.C.A.).

[27] *W.T. Ramsay Ltd. v. Internal Revenue Commissioners*, [1981] 1 All E.R. 865 (H.L.). [*Ramsay*]; *Commissioners of Inland Revenue v. Burmah Oil*, [1981] T.R. 535 (H.L.); and *Furniss (Inspector of Taxes) v. Dawson*, [1984] All E.R. 530 (H.L.).

[28] 1984 SCC 25, [1984] 1 S.C.R. 536, [1984] C.T.C. 294, 84 D.T.C. 6305 [*Stubart*].

[29] E.A. Driedger, *Construction of Statutes*, 2nd ed. (Butterworths, Toronto, 1983) at 87, cited in *Stubart, ibid.* at para 61.

[30] 1986 SCC 5, [1986] S.C.R. 209, [1986] 1 C.T.C. 274, 86 D.T.C. 6138 [*Golden*].

[31] *Ibid.* at para. 10.

[32] *Stubart*, *supra* note 28 at para. 53.

[33] *Ibid.* at para. 9. The transactions involved a sale of the taxpayer's business to a related company pursuant to an agreement, whereby the taxpayer continued to operate the business as the purchaser's agent, remitting the net income from the business to the purchaser which used accumulated tax losses from prior years to shelter the income from tax. After the accumulated tax losses were exhausted, the business was sold back to the taxpayer.

[34] *Ibid.* at para. 55. According to Justice Estey: "A strict business purpose test in certain circumstances would run counter to the apparent legislative intent which, in the modern taxing statutes, we may have a dual aspect. Income tax legislation, such as the federal Act in our country, is no longer a simple device to raise revenue to meet the cost

the same time, the Court suggested that "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" might be reduced by an interpretive approach that could, among other things, ignore the "formal validity" of a transaction where "'the object and spirit' of [an] allowance or benefit provision is defeated by … procedures blatantly adopted by [a] taxpayer to synthesize a loss, delay or other tax saving device [.]"[35] Otherwise, however, the Court concluded that "where the substance of the Act, when the clause in question is contextually construed, is clear and unambiguous and there is no prohibition in the Act which embraces the taxpayer, the taxpayer shall be free to avail himself of the beneficial provision in question."[36]

Despite its reluctance to disregard the formal validity of the specific transactions in *Stubart*, subsequent Supreme Court of Canada tax decisions in the 1980s displayed a much greater willingness to question the characterization of transactions and relationships according to their legal form. In *Johns-Manville Canada Inc. v. The Queen*,[37] for example, the Court stated 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 guiding features" of the expenditure,[38] 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 …."[39]

In *Imperial General Properties Ltd. v. The Queen*,[40] where the taxpayer was assessed on the grounds that it was "controlled" by and therefore "associated" with a family holding company that held 90 percent of its common shares but only 50 percent of its voting shares,[41] 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,"[42] notwithstanding that it did not own a majority of the voting shares. Although earlier Supreme Court of Canada decisions had generally interpreted the

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of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no *bona fide* business purpose. Thus, by imposing a positive requirement that there be such a *bona fide* business purpose, a taxpayer might be barred from undertaking the very activity Parliament wishes to encourage." In a concurring judgment, Justice Wilson rejected the adoption of a business purpose test (at paras. 71-72) on the grounds that it is "a complete rejection" of Lord Tomlin's principle from the *Duke of Westminster* case that taxpayers may order their affairs to minimize tax and that "Lord Tomlin's principle is far too deeply entrenched in our tax law for the courts to reject it in the absence of clear statutory authority."

[35] *Ibid*. at paras. 63-64.

[36] *Ibid*. at para. 64.

[37] 1985 SCC 44, [1985] 2 S.C.R. 45, 2 C.T.C. 111, 85 D.T.C. 5373 [*Johns-Manville*]

[38] *Ibid*. at para. 41, citing the decision of the Privy Council in *B.P Australia Ltd. v. Commissioner of Taxation of the Commonwealth of Australia*, [1966] A.C. 224 (P.C.) at 264, *per* Lord Pearce.

[39] *Johns-Manville*, *supra* note 37 at para. 42, citing the decision of the Australian High Court in *Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation* (1946), 72 C.L.R. 634 (Aust. H.C.) at 648, *per* Dixon J.

[40] [1985] 2 S.C.R., 288, [1985] 2 C.T.C. 299, 85 D.T.C. 5500 [*Imperial General Properties*].

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

[42] *Imperial General Properties*, *supra* note 40 at para. 14.

concept of corporate control as the *de jure* "right of control that rests in ownership of such a number of shares as carried with it the right to a majority of the votes in the election of the board of directors,"[43] the Court characterized its approach as "the ordinary progression of the judicial process,"[44] and declared that:

> 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.[45]

While the Supreme Court of Canada's decisions in *Johns-Manville* and *Imperial General Properties* demonstrated that the Court was increasingly willing to characterize 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*,[46] in which the Minister disallowed the deduction of borrowed funds used by the taxpayer to finance distributions to its sole beneficiary on the basis that the funds were not "used for the purpose of earning income from a business or property" as required by the relevant statutory provision.[47] Rejecting the taxpayer's main argument that the borrowed funds were used *indirectly* to earn income from property since they allowed it to "retain income-producing investments,"[48] the Court held that indirect income-earning uses are generally incompatible with the purpose of the provision to "encourage … taxpayers to augment their income-producing capacity,"[49] and that "a real appreciation of the taxpayer's transactions" did not support a *bona fide* indirect use since the interest expenses on the funds borrowed by the trust greatly exceeded the income from assets

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[43] *Buckerfield's Ltd. v. Minister of National Revenue*, [1964] C.T.C. 504, 64 D.T.C. 5301 (Exch. Ct.) at para. 10, cited with approval in *Dworkin Furs (Pembroke) Ltd. v. Minister of National Revenue*, [1967] C.T.C. 50, 67 D.T.C. 5035 (S.C.C.); *Vina-Rug (Can.) Ltd. v. Minister of National Revenue*, [1968] C.T.C. 1, 68 D.T.C. 5021 (S.C.C.); and *Donald Applicators Ltd. v. Minister of National Revenue*, [1969] C.T.C. 98, 69 D.T.C. 5122 (S.C.C.). The Supreme Court of Canada departed from this approach in *Oakfield Developments (Toronto) Ltd. v. Minister of National Revenue*, [1971] C.T.C. 283, 71 D.T.C. 5175 (S.C.C.), concluding on facts similar to those in *Imperial General Properties*, *supra* note 40, that common shareholders holding 50 percent of the voting shares controlled a company by virtue of their ability to cause the corporation to be wound up on economically favourable terms.

[44] *Imperial General Properties*, *supra* note 40 at para. 16.

[45] *Ibid*. at para. 11. In a strongly worded dissent, Justice Wilson (McIntyre J. and Lamer J., as he then was, concurring) acknowledged (*ibid*. at para. 35) that "the scope of scrutiny under the *de jure* test has been extended beyond a mere examination of the share register in order to determine who really has voting control," but insisted that the Court's decision in *Oakfield*, *supra* note 62, represented a "departure by the courts from a well-settled line of authority" according to which "voting control is the proper *indicium* of control." According to Justice Wilson: "I am of the view, therefore, that the decision in *Oakfield* is anomalous and should not be followed. For the courts suddenly to change direction in the face of well-settled and long-standing authority in our tax jurisprudence is, in my view, quite inappropriate…. I do not think that this is a suitable area for judicial creativity. People plan their personal and business affairs on the basis of the existing law and they are entitled to do so." *Imperial General Properties*, *supra* note 40 at para. 35.

[46] 1987 SCC 1, [1987] 1 S.C.R. 32, [1987] 1 C.T.C. 117, 87 D.T.C. 5059 [*Bronfman Trust*]. For a more detailed discussion of the case, see David G. Duff, "Interpreting the *Income Tax Act* — Part 1: Interpretive Doctrines" (1999), 47 *Can Tax J.* 464 at 489-494.

[47] ITA, subparagraph 20(1)(c)(i).

[48] *Bronfman Trust*, *supra* note 46 at para. 9.

[49] *Ibid*. at para. 51. See also *ibid*. at para. 50: "… despite the fact that it can be characterized as indirectly preserving income, borrowing money for an ineligible direct purpose ought not entitle a taxpayer to deduct interest payments."

that the borrowed funds allowed the trust to retain.[50] The Court also rejected the taxpayer's alternative argument that it could have deducted the interest expenses if it "had sold assets to pay the allocations and then borrowed money to replace them,"[51] on the grounds that "courts must deal with what the taxpayer actually did, and not what he might have done,"[52] and that the hypothetical transactions would be "the epitome of formalism" and might well be regarded as "a formality or a sham designed to conceal the essence of the transaction, namely that the money was borrowed and used to fund a capital allocation to the beneficiary."[53] With respect to each of the taxpayer's arguments, therefore, the Court bolstered its initial conclusions – that the borrowed funds were not directly used to earn income and that the hypothetical transactions were not carried out – with substantive arguments based on "a real appreciation of the taxpayer's transactions" and the "essence" of the hypothetical transactions.

In addition to these substantive responses to the taxpayer's arguments, the Court's decision in *Bronfman Trust* also stands out for its explicit disapproval of the traditional Anglo-Canadian approach according to which tax consequences should depend on the legal form of transactions and relationships regardless of their commercial or economic reality. According to the Court:

> … just as there has been a recent trend away from strict construction of statutes (see *Stubart* … and … *Golden*…), so too has the recent trend in tax cases been towards attempting to ascertain the true commercial and practical nature of the taxpayer's transactions. There has been, in this country and elsewhere, a movement away from tests based on the form of transactions and towards tests based on what Lord Pearce has referred to as a "common sense appreciation of all the guiding features" of the events in question ….[54]

Welcoming this development as "a laudable trend provided that it is consistent with the text and purposes of the taxation statute,"[55] the Court concluded that this substantive approach to the characterization of transactions and relationships could help to promote tax fairness by limiting opportunities for tax avoidance:

> 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.[56]

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[50] *Ibid*. at para. 52.
[51] *Ibid*. at para. 9.
[52] *Ibid*. at para. 53.
[53] *Ibid*., citing *Zwaig v. M.N.R.*, [1974] C.T.C. 2172 (T.R.B.), in which the taxpayer sold securities, used the proceeds to purchase a life insurance policy, and then borrowed on the policy to repurchase the securities. According to the Court: "The Tax Review Board rightly disallowed the deduction sought for interest payments, notwithstanding that the form of the taxpayer's transactions created an aura of compliance with the requirements of the interest deduction provision."
[54] *Bronfman Trust*, *supra* note 46 at para. 48.
[55] *Ibid*. at para. 49.
[56] *Ibid*.

As the Courts decisions in *Stubart* and *Golden* rejected the literalism of traditional Anglo-Canadian tax jurisprudence, therefore, its decision in *Bronfman Trust* challenged the traditional emphasis that this tax jurisprudence had placed on the legal form of transactions and relationships irrespective of their "commercial and economic realities".

Despite these judicial developments, however, the Court's rejection of a broad business purpose test in *Stubart* convinced the federal government that a statutory GAAR was required to direct courts to help prevent abusive tax avoidance. Explaining that "existing provisions of the *Income Tax Act* are inadequate to deal with a number of blatant tax avoidance arrangements" and that "a change in direction is required to reduce what was succinctly described by the Supreme Court of Canada in the *Stubart* case … 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,'"[57] the government proposed a draft rule in 1987 "to prevent artificial tax avoidance arrangements" by introducing a business purpose test and a step-transaction concept into the *ITA*.[58] After more than a year of discussion and commentary on the draft,[59] the Canadian GAAR was enacted and came into force for most transactions entered into on or after 13 September 1988.

3. The Basic Structure and Interpretation of the Canadian GAAR

As mentioned in the introduction to this paper, the effect of the GAAR is to deny tax benefits resulting from tax-motivated transactions that result in a misuse of other provisions of the *ITA* or other enactments such as regulations or tax treaties, or an abuse "having regard to these provisions read as a whole". More precisely, subsection 245(2) of the *ITA* stipulates that:

> Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section would result, directly or indirectly, from that transaction or from a series of transactions that included that transaction.

For the purpose of this provision, subsection 245(3) defines an avoidance transaction as a transaction that, but for the GAAR, would either alone or as part of a series of transactions result directly or indirectly in a tax benefit, "unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit." In addition to this provision, subsection 245(2) provides that subsection 245(2) applies to a transaction only if it may reasonably be considered that the transaction would, if the *ITA* were read without reference to the GAAR, result directly or indirectly in a misuse of any one or

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[57] Canada, Department of Finance, *The White Paper: Tax Reform 1987* (Ottawa: Department of Finance, 18 June 1987), reproduced in *White Paper on Tax Reform* (Don Mills, ON: CCH, 1987) 23 at 70, citing *Stubart*, *supra* note 28 at para. 67.
[58] *Ibid*.
[59] See, e.g., Brian J. Arnold & James R. Wilson, "The General Anti-Avoidance Rule — Parts 1, 2, and 3" (1988) 36:4-6 Can. Tax J. 829-87, 1123-85, and 1369-1410; and Howard J. Kellough, "A Review and Analysis of the General Anti-Avoidance Rule" (1988) 36:1 Can. Tax J. 23-78.

more of the provisions the *ITA* or other relevant enactments or an abuse, having regard to those provisions other than the GAAR, read as a whole.

Together these provisions create three requirements for the GAAR to apply to a transaction:

> (1) the transaction or a series of transactions that included the transaction would, but for the GAAR, result directly or indirectly in a tax benefit;
>
> (2) the transaction cannot reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; and
>
> (3) the transaction could, if the *ITA* were read without reference to the GAAR, reasonably be considered to result, directly or indirectly, in a misuse of any one or more of the provisions the *ITA* or other relevant enactments or an abuse, having regard to those provisions, read as a whole.

The following sections consider each of these requirements, as well as the tax consequences that may result if the GAAR applies.

(a) Tax Benefit Resulting from a Transaction or Series of Transactions

Beginning with the concept of a transaction, subsection 245(1) defines this term expansively to include "an arrangement or event". Since a tax benefit may result not only from an individual transaction, but also from a number of transactions, the GAAR also applies to tax benefits that result from a series of transactions that includes an avoidance transaction.

Although the *ITA* does not define the concept of a series of transactions, subsection 248(10) extends the meaning of this term to include "related transactions or events completed in contemplation of the series." In this context, the Supreme Court of Canada has held that the ordinary meaning of a series of transactions contemplates "a number of transactions that are 'pre-ordained in order to produce a given result' with 'no practical likelihood that the pre-planned events would not take place in the order ordained'",[60] while the extended meaning includes transactions completed before or after an ordinary series that are connected to the ordinary series because they are completed "because of" or "in relation to" the series .[61]

The concept of a tax benefit is defined quite broadly in subsection 245(1) as:

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[60] *Canada Trustco Mortgage Co. v Canada*, 2005 SCC 56, [2005] 2 SCR 601, [2005] 5 C.T.C.215, 2005 D.T.C. 5523 [*Canada Trustco*], at para. 25, citing *Craven v. White*, [1989] A.C. 398 (H.L.) at 514, *per* Lord Oliver; and *Ramsay*, *supra* note 27.

[61] *Ibid*. at para. 26, citing David G. Duff, "Judicial Application of the General Anti-Avoidance Rule in Canada: *OSFC Holdings v. The Queen*" (2003), 57 I.B.F.D. Bulletin 278 at 287. Although the conclusion that the extended meaning of a series of transactions can include a subsequent related transaction has been criticized as a strained interpretation of the words "in contemplation of", the Supreme Court of Canada reaffirmed this interpretation in *Copthorne Holdings v. Canada*, 2011 SCC 63, [2011] 3 SCR 721, [2012] 2 C.T.C. 29, 2012 D.T.C. 5007 [*Copthorne*] at paras. 50-58.

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

In contrast to more limited anti-avoidance rules, therefore, the scope of the GAAR is virtually unlimited, applying to any tax advantage obtained under the *ITA* or a tax treaty, whether this involves the deduction of an amount; the reduction, avoidance, or deferral of tax by any other means; the reduction, avoidance, or deferral of other amounts payable under the Act, such as interest and penalties; or an increase in amounts refunded to the taxpayer on account of tax or other amounts such as interest and penalties.

Although this definition of a tax benefit may seem relatively straightforward, the notion of a "reduction, avoidance or deferral of tax or other amount payable" or "an increase in a refund of tax or other amount" implicitly assumes some notional amount of tax, refund or other amount that would have existed but for the transaction or series of transactions.[62] For this purpose, the Supreme Court of Canada has held that a tax benefit may be identified by comparing the tax consequences resulting from the transaction or series of transactions carried out by the taxpayer with the tax consequences resulting from an "alternative arrangement … that 'might reasonably have been carried out but for the existence of the tax benefit.'"[63] In cases where it is unreasonable to conclude that the taxpayer would have carried out any transaction or series of transactions but for the tax benefit, a tax benefit might reasonably be assessed by comparing the tax consequences resulting from the transaction or series of transactions with the tax consequences that would have resulted had the transaction or series of transactions not been carried out.[64] However determined, the Supreme Court of Canada has also held that the existence of a tax benefit is "a factual determination, initially by the Minister and on review by the courts, usually the Tax Court.," and that the burden of proof is on the taxpayer to refute the "underlying assumptions of facts" on which the Minister's assessment is based.[65]

(b) Non-Tax Purpose Test

Although a transaction or series of transactions may result in a tax benefit, the GAAR applies only to avoidance transactions as defined in subsection 245(3), which explicitly excludes transactions that "may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit." Aptly described as "an expanded version of the business purpose test" that the Supreme Court of Canada rejected in *Stubart*

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[62] See, *e.g.*, *McNichol v. Canada*, [1997] T.C.J. No. 5, [1997] 2 C.T.C. 2088, 97 D.T.C. 111 (T.C.C.) [*McNichol*] at para. 20: "There is nothing mysterious about the subs. 245(1) concept of tax benefit. Clearly a reduction or avoidance of tax does require the identification in any given set of circumstances of a norm or standard against which reduction is to be measured."

[63] *Copthorne*, *supra* note 61 at para. 35, citing David G. Duff, et. al. *Canadian Income Tax Law*, 3d ed. (Markham: LexisNexis Butterworths, 2009) at p. 187.

[64] Arnold and Wilson, "The General Anti-Avoidance Rule — Part 2," *supra* note 59 at 1154-55.

[65] *Canada Trustco*, *supra* note 60 at paras. 19 and 64. This conclusion was reaffirmed in *Copthorne*, *supra* note 61 at para. 34.

Investments,[66] this language excludes from the GAAR not only transactions carried out for *bona fide* business purposes, but also transactions undertaken primarily for other non-tax reasons such as family or investment purposes.[67]

As the Supreme Court of Canada has explained that the words "reasonably" and "primarily" suggest that this non-tax purpose test is both objective and comparative, contemplating "an objective assessment of the relative importance of the driving forces of the transaction."[68] As a result, as the Federal Court of Appeal has held, "the focus will be on the relevant facts and circumstances and not on statements of intention."[69] For this reason, the Supreme Court of Canada has also concluded that the determination of whether a transaction can reasonably be considered to have been undertaken or arranged primarily for *bona fide* reasons other than to obtain a tax benefit is a factual determination, in which the taxpayer bears the burden of disproving the "underlying assumptions of facts" on which the Minister's assessment is based,[70] and emphasized that appellate courts should accord considerable deference to the findings of the Tax Court judge, where these are "supported by the evidence."[71]

(c) Misuse or Abuse Requirement

In addition to the requirements that a transaction result in a tax benefit and cannot reasonably be considered to have been undertaken for a *bona fide* purpose other than to obtain the tax benefit, subsection 245(4) of the *ITA* creates an additional requirement that the transaction must also result directly or indirectly in a misuse of one or more provisions of the *ITA* or other relevant provisions or an abuse having regard to those provisions read as a whole.

This stipulation did not appear in the original draft version of the proposed rule, which included a general interpretive provision indicating that the purpose of the section was "to counter artificial tax avoidance." In response to concerns that the original formulation of this interpretive provision was unclear and that the anti-avoidance rule might apply to tax-motivated transactions that are specifically encouraged by or consistent with provisions of the Act,[72] the interpretive provision was replaced with the misuse or abuse requirement in subsection 245(4). As the Supreme Court of Canada has explained, its effect is to limit the scope of the GAAR to abusive avoidance transactions, drawing a line between "legitimate tax minimization" to which the GAAR does not apply and "abusive tax avoidance" to which it does.[73]

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[66] Arnold and Wilson, "The General Anti-Avoidance Rule — Part 2," *supra* note 59 at 1159.
[67] *Canada Trustco*, *supra* note 60 at para. 33 (noting that the expression "non-tax purpose" has a broader meaning than the expression "business purpose").
[68] *Ibid*. at para. 28.
[69] *OSFC Holdings Ltd. v. Canada*, [2001] F.C.J. No. 1381, [2001] 4 C.T.C. 82, 2001 D.T.C. 5471 (F.C.A.) at para. 46 [*OSFC*].
[70] *Canada Trustco*, *supra* note 60 at para. 63.
[71] *Ibid*. at para. 66,
[72] See, for example, David C. Nathanson, "The Proposed General Anti-Avoidance Rule" in *Report of Proceedings of the Thirty-Ninth Tax Conference*, 1987 Conference Report (Toronto: Canadian Tax Foundation, 1988) 9:127 at 23-26.
[73] *Canada Trustco*, *supra* note 60 at para. 16.

Generally regarded as "the most difficult" aspect of the GAAR,[74] the characterization of an avoidance transaction as abusive is ultimately a matter of statutory interpretation, in which a court must first "determine the object, spirit or purpose of the provisions" that are relied upon in order to obtain the tax benefit, and then decide whether the transaction defeats or frustrates this identified purpose.[75] Unlike ordinary statutory interpretation, however, in which the interpretive enterprise is aimed at the meaning of the relevant statutory text, the first step of a GAAR analysis seeks "the rationale that underlies the words that may or may not be captured by the bare meaning of the words."[76] In this respect, the Supreme Court has stated:

> The GAAR is a legal mechanism whereby Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer.[77]

Once this object, spirit or purposes is determined, the Court has held, the second step of a GAAR analysis will lead to a finding of abusive tax avoidance where: (1) a transaction achieves an outcome that the relevant statutory provisions seek to prevent; (2) the transaction defeats the underlying rationale of the relevant provisions; or (3) the transaction circumvents relevant provisions in a manner that frustrates or defeats their object, spirit or purpose.[78]

(d) Tax Consequences

Where the GAAR applies to an avoidance transaction, subsection 245(2) provides "the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny [the] tax benefit" that would otherwise result from the transaction or series of transactions of which the avoidance transaction is a part. For this purpose, subsection 245(1) defines the term "tax consequences" broadly as "the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount." In addition, without restricting the generality of subsection 245(2), subsection 245(5) provides that the GAAR may be used to (a) allow or disallow in whole or in part any deduction, exemption or exclusion in computing income, taxable income, taxable income earned in Canada or tax payable, (b) allocate any deduction, exemption, exclusion, income, loss or other amount to any person, (c) recharacterize the nature of any payment or other amount, and (d) ignore the tax effects that would otherwise result from the application of other provisions of the *ITA*.

Unlike more limited anti-avoidance rules, the scope of these remedial powers is extremely broad, authorizing adjustments to any amount relevant to a taxpayer's current or future tax liability. At the same time, subsection 245(2) limits these powers in two important ways, specifying that they must be determined "as is reasonable in the circumstances" and only "in order to deny the tax benefit". As a result, although the GAAR gives courts considerable scope to

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74 *Ibid*. at para. 37.
75 *Ibid*. at para. 55.
76 *Copthorne*, *supra* note 61 at para. 70.
77 *Ibid*. at para. 66.
78 *Canada Trustco*, *supra* note 60 at para. 45; reaffirmed in *Copthorne*, *supra* note 61 at para. 71.

determine appropriate tax consequences for the variety of avoidance transactions to which the provision might apply, its purpose is not to penalize taxpayers who engage in abusive tax avoidance, but simply to deny the tax benefits that would otherwise result from abusive tax avoidance transactions.

Because the tax consequences determined under the GAAR are those that are reasonable in order to deny the tax benefit, moreover, the considerations determining the remedial effects of the GAAR are necessarily related to those governing its application in the first place. In particular, just as the characterization of an avoidance transaction depends on a "benchmark" against which to identify a tax benefit, so also does the determination of "reasonable tax consequences" to deny a tax benefit.

4. Tax Avoidance and Statutory Interpretation after the GAAR

Since the GAAR applies only to transactions entered into on or after September 13, 1988, the first case to consider the provision was not decided until 1997,[79] and the Supreme Court of Canada did not rule on its application until 2005 – when it decided two cases simultaneously, applying the GAAR in one of these decisions,[80] but not the other.[81] Since then, the Court has released only two more GAAR judgments in which the GAAR was applied.[82] In addition to these four cases, however, the GAAR has also been considered in a much larger number of lower court decisions, in which it has been applied much less frequently.[83]

The following sections review key tax avoidance cases following the introduction of the GAAR, beginning with Supreme Court of Canada cases involving pre-GAAR transactions and lower court GAAR cases in the period before 2005, turning next to the first Supreme Court of Canada GAAR judgments and their impact on lower court GAAR decisions, and finally considering the Supreme Court of Canada's most recent GAAR decision and its impact on more recent GAAR decisions.

(a) Tax Avoidance at the Supreme Court of Canada, 1988-2005

After the GAAR was enacted in 1988, one might have thought that the Supreme Court of Canada would have followed the legislature's lead by continuing to apply the purposive and substantive approach that it had adopted in the mid-1980s to tax cases involving transactions entered into before the GAAR applied. Indeed, the Court did exactly this in *McClurg v.*

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[79] *McNichol*, *supra* note 62.
[80] *Mathew v. Canada*, 2005 SCC 55, [2005] 2 SCR 643, [2005] 5 C.T.C. 244, 2005 D.T.C. 5538 [*Mathew*].
[81] *Canada Trustco*, *supra* note 60.
[82] *Lipson v. Canada*, 2009 SCC 1, [2009] 1 SCR 3, [2009] 1 C.T.C. 314, 2009 D.T.C. 2015 [*Lipson*] and *Copthorne*, *supra* note 61.
[83] Considering GAAR decisions by the Supreme Court of Canada, the Federal Court of Appeal and the Tax Court of Canada, statistics drawn from Tax Foresight's Case Analytics function suggest that the provision has been applied in 40 judgments and not applied in 50, suggesting an overall application rate of 44 percent. Since at least some of the cases in which courts have held that the GAAR does not apply have applied more specific anti-avoidance rules instead, this ratio does not suggest the Crown's overall success rate in these cases.

Canada,[84] which was released in December 1990. Emphasizing that courts must "determine both the purpose of the legislative provision and the economic and commercial reality of the taxpayer's actions" in assessing the tax consequences of particular transactions,[85] a majority of the Court held that an income attribution rule did not apply to dividends received by the taxpayer's spouse on the grounds that the purpose of the provision does not generally contemplate dividends,[86] and that its application on the facts of the case "would be contrary to … commercial reality."[87] Over the next fifteen years, however, the Court rejected this approach, returning to the more textual and formalist approach that characterized traditional Anglo-Canadian tax jurisprudence.

The first indication of this change was the Court's 1994 decision in *Antosko v. The Queen*,[88] in which the Court held that the taxpayers were entitled to a deduction even if it resulted in a windfall that was not intended by the relevant provision.[89] Rejecting the Crown's argument that it would be contrary to the purpose of the provision to permit the taxpayers to claim the deduction, the Court stated that the purpose of a provision and the economic and commercial reality of a transaction "cannot alter the result where the words of the statute are clear and plain and … the legal and practical effect of the transaction is undisputed."[90] The following year, in *Friesen v. Canada*,[91] a majority of the Court reaffirmed this "plain meaning" approach to the interpretation of tax statutes, confirming a departure from the purposive approach of *Bronfman Trust* and *McClurg*.

As with this shift from purposive to textual interpretation, so also did the Court's judgments in these years abandon its earlier emphasis on commercial and economic reality in favour of a more formal approach emphasizing the legal character of transactions and arrangements, rather than their commercial or economic substance. In *Duha Printers (Western)*

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84 [1990] 3 S.C.R. 1020, [1991] 1 C.T.C. 169, 91 D.T.C. 5001 [*McClurg*]. For a detailed discussion of the case, see Duff, "Interpreting the *Income Tax Act* — Part 1" *supra* note 46 at 494-501.

85 *McClurg, ibid*. at para. 46.

86 *Ibid*. at paras. 48 and 49, explaining that the attribution rule "is obviously designed to prevent avoidance by the taxpayer, through the direction to a third party, of receipts which he or she otherwise would have obtained," and that "a dividend payment does not fall within the scope" of the provision because "in the corporate law context, until a dividend is declared, the profits belong to a corporation as a juridical person." For a critical analysis of this interpretation, arguing that it contradicts both the text and the purpose of the relevant provision, see Duff, "Interpreting the *Income Tax Act* — Part 1" *supra* note 46 at 499-501.

87 *McClurg*, *supra* note 84 at paras. 51 and 52, concluding that the dividends "represented a legitimate *quid pro quo*" for contributions that the taxpayer's spouse had made to the company paying the dividends "and were not simply an attempt to avoid the payment of taxes."

88 1994 SCC 46, [1994] 2 S.C.R. 312, [1994] 2 C.T.C. 25, 94 D.T.C. 6314 [*Antosko*]. For a more detailed discussion of the case, see Duff, "Interpreting the *Income Tax Act* — Part 1" *supra* note 46 at 507-511.

89 ITA, subsection 20(14). The purpose of this provision, as the Court acknowledged, is "to prevent double taxation" that might otherwise occur on the transfer of a debt obligation with accrued interest owing, which would be reflected in the purchase price of the obligation and included when received by the transferee. On the facts of the case, the taxpayers purchased a debt obligation with accrued interest for a nominal amount and subsequently received substantial interest payments that were sheltered by the deduction.

90 *Ibid*. at para. 29.

91 1995 SCC 71, [1995] 3 S.C.R. 103, [1995] 2 C.T.C. 369, 95 D.T.C. 5551 [*Friesen*]. For a detailed discussion of the case, see Duff, "Interpreting the *Income Tax Act* — Part 1" *supra* note 46 at 511-517.

Ltd. v. The Queen,[92] for example, in which the taxpayer entered into a series of transactions intended to circumvent a provision that generally prohibits the acquisition by unrelated persons of corporate losses that can be used to shelter income from tax,[93] the Court affirmed a narrow *de jure* concept of corporate control arguably at odds with its earlier decision in *Imperial General Properties*. Notwithstanding that the taxpayer acquired the shares of a company only a day after issuing a majority of its own voting shares to the company's sole shareholder, which entered into a unanimous shareholder's agreement depriving it of real or effective control of the taxpayer, the Court concluded that the provision did not apply because the taxpayer and a company the shares of which it acquired in order to obtain the company's losses were both controlled by the same person and therefore related immediately before this transaction.[94]

Emphasizing that "taxpayers rely heavily on whatever certainty and predictability can be gleaned from the *Income Tax Act*," the Court in *Duha* rejected the Crown's argument that corporate control should be broadly interpreted as actual control in favour of a "simple test" based on *de jure* control.[95] It also rejected the suggestion that the taxpayer should not be able to benefit from tax-motivated transactions contrary to the object and spirit of the relevant provision on the grounds that the *Stubart* decision established that "no 'business purpose' is required for a transaction to be considered valid under the *Income Tax Act*, and that a taxpayer is entitled to take advantage of the Act even where a transaction is motivated solely by the minimization of tax."[96] Despite the GAAR, therefore, the Court was not only unwilling to extend its principles to transactions entered into before this provision came into force, but was also unwilling to apply the more substantive approach of its earlier jurisprudence in order to limit opportunities for abusive tax avoidance.

In addition to *Duha*, other Supreme Court of Canada decisions during this period adopted a similarly formalistic approach to the *ITA*, eschewing considerations of commercial or economic reality and sanctioning tax-motivated transactions contrary to the object and purpose of specific provisions or the *ITA* as a whole. In *Neuman v. M.N.R.*,[97] for example, which was released a week before *Duha*, the Court relied on its earlier decision in *McClurg* to hold that an income attribution rule did not apply to discretionary dividends paid by a private corporation to the taxpayer's spouse, notwithstanding that she had made no contribution to the business (unlike the taxpayer's spouse in *McClurg*) and that the arrangement appears to have been purely tax-motivated in order to split income. Concluding that the attribution rule was limited in its scope

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92 [1998] 1 S.C.R. 795, [1998] 3 C.T.C. 303, 98 D.T.C. 6334 [*Duha*]. For a more detailed discussion of this case, see Duff, "Justice Iacobucci," *supra* note 3 at 547-556.

93 ITA, subsection 111(5), which generally limits the carryover of losses when a taxpayer is subject to a "loss restriction event", paragraph 251.2(2)(a) which defines a loss restriction event to include the acquisition of control of a corporation, and paragraph 256(7)(a) which deems control of a corporation not to have been acquires because of an acquisition of shares by a person related to the corporation. Although substantially amended since the transactions at issue in *Duha*, the effect of these provisions is the same as the provisions considered in the case.

94 See ITA, subparagraph 251(2)(c)(i), which deems two corporations to be related if they are controlled by the same person or group of persons.

95 *Duha*, *supra* note 92 at para. 52.

96 *Ibid*. at para. 87.

97 1998 SCC 37, [1998] 1 S.C.R. 770, [1998] 3 C.T.C. 177, 98 D.T.C. 6297 [*Neuman*]. For a critical analysis of the decision, see David G. Duff, "*Neuman* and Beyond: Income Splitting, Tax Avoidance, and Statutory Interpretation in the Supreme Court of Canada" (1999), 32 *Can. Bus L.J.* 345.

and that the *ITA* contains “no general scheme to prevent income-spitting,”[98] the Court also emphasized that it was “important to remember that this Court held unanimously in *Stubart* … that a transaction should not be disregarded for tax purposes because it has no independent or *bona fide* purpose …” and that “taxpayers can arrange their affairs in a particular way for the sole purpose of deliberately availing themselves of tax reduction devices in the *ITA*.”[99]

A year and a half later, in *Shell Canada Ltd. v. The Queen*,[100] the Court sanctioned what a prominent Canadian commentator denounced as a “blatant tax avoidance scheme”[101] in which the taxpayer engaged in a so-called “weak currency borrowing” – borrowing New Zealand dollars at a high interest rate, converting these to U.S. dollars for use in its business, and entering into forward currency exchange agreements to convert U.S. dollars back into New Zealand dollars to make payments of interest and principal – thereby obtaining higher deductions on the interest payments and partly taxable capital gains on the currency exchange agreements. Concluding that the borrowed funds were used for the purpose of earning income as required by the relevant statutory provision, the Court allowed the deduction of the increased interest expense, notwithstanding that the sole purpose of the New Zealand borrowing was to reduce tax. According to the Court:

> ... absent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way.... Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.[102]

Most significant, perhaps, is the Court’s 2001 decision in *Ludco Enterprises Ltd. v. The Queen*,[103] in which the taxpayers sought to deduct interest on borrowed funds used to acquire shares of two offshore companies that used the funds to purchase debt-securities and reinvest almost all profits, paying dividends that were much less than the interest expenses on the borrowed funds, which enabled the taxpayers to use the deduction to shelter other income from tax.[104] Rejecting the Crown’s argument that the real purpose for which the borrowed funds were

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[98] *Neuman*, *ibid.*, at para. 35, citing V. Krishna and J.A. VanDuzer, “Corporate Share Capital Structures and Income –Splitting: *McClurg v. Canada*” (1992-93), 21 *Can. Bus L.J.* 335 at 367.
[99] *Neuman*, *ibid*., at para. 39.
[100] 1999 SCC 30, [1999] 3 S.C.R. 622, [1999] 4 C.T.C. 313, 99 D.T.C. 5669 [*Shell*]. For a detailed discussion of this case, see David G. Duff, “Weak Currency Borrowings and the General Anti-Avoidance Rule in Canada: From *Shell Canada* to *Canadian Pacific*” (2001), 55 *Bulletin for International Fiscal Documentation* 233.
[101] Brian J. Arnold, “Supreme Court of Canada Sanctions Blatant Tax Avoidance Scheme” (1999), 19 *Tax Notes International* 1813.
[102] *Shell*, *supra* note 100 at para. 45.
[103] 2001 SCC 63, [2001] 2 S.C.R. 1082, [2002] 1 C.T.C. 95, 2001 D.T.C. 5518 [*Ludco*]. For a more detailed discussion of this case, see Duff, “Justice Iacobucci” *supra* note 3 at 556-562.
[104] As the Court notes, ownership of these companies was “carefully structured” to avoid the application of Canada’s foreign accrual property income (FAPI) rules that attribute passive income of controlled foreign corporations to Canadian shareholders. These rules were amended in 1994 to prevent structures like those established by the taxpayers.

used was to realize partly-taxable capital gains when shares of the companies were sold, not income from a business or property as required by the relevant statutory provision, the Court allowed the deduction on the grounds that borrowed funds can be used to earn gross income not net income,[105] and that the borrowed funds were used to earn at least some income in the form of dividends even if the primary purpose was to realize capital gains.[106] More generally, the Court stated:

> … given that the *Income Tax Act* has many specific anti-avoidance provisions and rules, it follows that courts should not be quick to embellish the provisions of the Act in response to concerns about tax avoidance when it is open to Parliament to be precise and specific with respect to any mischief to be prevented …. To 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 ….[107]

As a result, the Court suggested, even if a specific statutory provision might be interpreted to discourage or prevent tax avoidance, courts should forswear such an interpretation on the grounds that taxpayers are entitled to arrange their affairs solely to minimize taxes absent a precise and specific statutory anti-avoidance provision to the contrary. Contrary to the GAAR, therefore, and in contrast to the Court's decisions in *Stubart* and *Bronfman Trust,* which assumed at least some judicial responsibility to limit tax avoidance,[108] this passage suggested that tax avoidance was properly a matter for the legislature, not the courts. In fact, the legislature responded to each of the decisions in *Duha*, *Neuman*, *Shell*, and *Ludco* with specific anti-avoidance rules[109] – though not always quickly and not always successfully, resulting in

[105] *Ludco*, *supra* note 103 at paras. 57-65, concluding among other things that this interpretation is consistent with the purpose of the interest deduction "to create an incentive to accumulate income producing capital … [that] creates wealth and increases the income tax base." Since a deduction in excess of income actually reduces the income tax base, this conclusion is questionable. More significantly, the Court's interpretation ignores the words "income *from a business or property*" in the relevant provision, which is defined in subsection 9(1) of the ITA as "the taxpayer's *profit* from that business or property" which is a net concept.

[106] *Ibid*. at paras 50-51, concluding that "a taxpayer who uses borrowed money to make an investment for more than one purpose may be entitled to deduct interest charges provided that one of the purposes was to earn income" and that "a taxpayer's ancillary purpose may be… capable of providing the requisite purpose for interest deductibility in comparison with any more important or significant primary purpose."

[107] *Ibid*. at para. 39.

[108] See *Stubart*, *supra* note 28 at paras. 63-64 (suggesting that an interpretive approach emphasizing the "object and spirit" of taxing provisions would "reduce 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"); and *Bronfman Trust*, *supra* note 46 at para. 49 (stating that "[a]ssessment 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").

[109] See, e.g., ITA, subsection 256.1(6) which would prevent the outcome in *Duha*, *supra* note 92; section 120.4 which limits opportunities for income-splitting with discretionary dividends; section 20.3 which limits the deduction of interest expenses on weak currency borrowings; and proposed section 3.1 which would have required taxpayers to demonstrate a reasonable expectation of profit in order to deduct losses.

undetermined revenue losses.[110] And the Court's hands off attitude to tax avoidance during this period encouraged tax advisors and their clients to carry on devising and implementing aggressive tax avoidance strategies, which the Canadian tax system continues to address.

(b) Lower Court GAAR Cases, 1997-2005

By the time that the Supreme Court of Canada released its decisions in *Duha, Neuman*, *Shell*, and *Ludco*, lower courts had begun to rule on cases involving the GAAR. Although a few of these cases adopted a narrow interpretive approach, relying on pre-GAAR jurisprudence to assess transactions subject to the GAAR,[111] others took a broader view, concluding that tax avoidance transactions were subject to the GAAR on the grounds that they either misused specific provisions of the *ITA* or abused a more general statutory scheme.

In the first two GAAR cases, for example,[112] the Tax Court of Canada concluded that tax-motivated "surplus stripping" transactions designed to convert otherwise taxable dividends into lower-taxed capital gains, were contrary to the scheme of the *ITA*, which generally "calls for the treatment of distributions to shareholders of corporate property as income."[113] According to the second of these judgments:

> … the *Income Tax Act*, read as a whole, envisages that a distribution of corporate surplus to shareholders is to be taxed as a payment of dividends. A form of transaction that is otherwise devoid of any commercial objective, and that has as its real purpose the extraction of corporate surplus and the avoidance of the ordinary consequences of such a distribution, is an abuse of the Act as a whole.[114]

Similarly in *Duncan v. Canada*,[115] where a partnership attempted to take advantage of a gap in Canadian tax rules to claim a loss on the disposition of an obsolete computer that had been written down for U.S. tax purposes while the partnership carried on business in the United States but was valued at its original cost for Canadian tax purposes, the Federal Court of Appeal applied the GAAR to disallow the loss on the basis that this outcome would be "contrary to the scheme of the capital cost allowance provisions which limits the deduction of capital expenditures to those incurred for the purpose of earning income under the Act."[116] The Court also rejected the taxpayer's argument that a subsequent amendment that would have denied the

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[110] Subsection 256.1, for example, was not enacted until 2013, fifteen years after *Duha*, *supra* note 92, the tax on split income in section 120.4 originally applied only to minor children and was only recently extended to spouses after a difficult political debate, and the statutory reasonable expectation of profit test in proposed section 3.1 was never enacted into law.

[111] See, e.g., *Canadian Pacific Ltd. v. The Queen*, [2001] 1 C.T.C. 2190, 2000 D.T.C. 2428 (T.C.C.), aff'd [2002] 2 C.T.C. 197, 2002 D.T.C. 6742 (F.C.A.), in which the court relied on the Supreme Court of Canada decision in *Shell*, *supra* note 100 to conclude that a weak-currency borrowing did not result in a misuse of the interest deduction.

[112] *McNichol*, *supra* note 62; and *RMM Canadian Enterprises Inc. v. Canada*, [1998] 1 C.T.C. 2300, 97 D.T.C. 302 (T.C.C.) [*RMM*].

[113] *McNichol*, *supra* note 62 at para. 24.

[114] *RMM*, *supra* note 112 at para. 53.

[115] [2002] 4 C.T.C. 1, 2002 D.T.C. 7172 (F.C.A.).

[116] *Ibid*. at para. 44.

loss confirmed that the transactions were not abusive before this change,[117] concluding that "this amendment demonstrates that Parliament moved as quickly as it could to close the loophole exploited by the appellants precisely because the result achieved was anomalous having regard to the object and spirit of the relevant provisions of the Act."[118]

The most important GAAR case during this period is *OSFC Holdings Ltd. v. Canada*,[119] in which the Federal Court of Appeal applied the GAAR to a series of transactions by means of which the taxpayer sought to deduct accrued losses on the disposition of property originally owned by an unrelated corporation. In order to transfer these losses, the acquisition of which by the taxpayer would have been prevented by specific anti-avoidance rules if the taxpayer had acquired control of the unrelated corporation directly,[120] the corporation first transferred the property to a related partnership, the taxpayer then purchased the corporation's interest in the partnership, and the partnership ultimately disposed of the property thereby realizing the losses. Under a so-called "stop-loss" rule that prevents taxpayers from realizing tax losses when they do not dispose of their economic interest in property, the losses were denied when the corporation transferred the property to the related partnership and added the cost of the property to the partnership,[121] effectively preserving the accrued losses in the hands of the partnership. When the taxpayer acquired the corporation's interest in the partnership and the partnership then disposed of the property, these losses flowed through to the taxpayer under *ITA* rules for allocating income and losses to members of partnerships.[122]

Concluding that the transactions comprised an extended series of transactions that resulted in a tax benefit when the taxpayer deducted the losses,[123] and that the taxpayer's acquisition of the corporation's partnership interest was primarily tax-motivated,[124] the Court's main contribution to judicial interpretation of the GAAR is its analysis of the misuse or abuse test in subsection 245(4) of the *ITA*.[125] For a misuse analysis, the Court concluded, courts must consider the "policy behind" specific provisions of the *ITA*.[126] An abuse analysis, on the other hand, requires "a consideration of the avoidance transactions in a wider context, having regard to the provisions of the *Income Tax Act* read as a whole and the policy behind them."[127] In each case, the Court reasoned that because the GAAR requires courts to go "behind" the word of the

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[117]*Ibid*. at para. 46, referring to ITA subsection 96(8), which writes down the undepreciated capital cost of depreciable property held by a partnership when it acquires a Canadian partner.
[118] *Ibid*. at para. 47.
[119] *OSFC*, *supra* note 69. For a more detailed discussion of the decision, see Duff, "Judicial Application of the General Anti-Avoidance Rule" *supra* note 61.
[120] In this circumstance, paragraph 249(4)(a) of the ITA would have deemed the corporation's taxation year to have ended immediately before the acquisition of control, subsection 10(1) would have triggered the losses by writing down the value of the property to its fair market value, and subsection 111(5) would have precluded the deduction of these losses in subsequent taxation years.
[121] ITA, subsection 18(13). This provision was subsequently amended to apply to transfers to a narrower category of "affiliated" (not related) persons, and to provide that the disallowed loss is deferred in the hands of the transferor rather than added to the cost of the property to the transferee, thereby preventing loss-trading transactions like those in *OSFC*.
[122] ITA, subsection 96(1).
[123] *OSFC*, *supra* note 69 at paras. 14-44.
[124] *Ibid*. at paras. 45-58.
[125] *Ibid*. at paras. 59-114.
[126] *Ibid*. at para. 61.
[127] *Ibid*.

statute – "invoking a policy to override the words that Parliament has used" – courts should "proceed cautiously" in carrying out "the unusual duty" imposed upon by the GAAR, determining that a transaction has resulted in a misuse or abuse only where the relevant policy is "clear and unambiguous."[128] As a result, it emphasized:

> … subsection 245(4) cannot be viewed as abdication by Parliament of its role as lawmaker in favour of the subjective judgment of the Court or particular judges. In enacting subsection 245(4), Parliament has placed the duty on the Court to ascertain Parliament's policy, as the basis for denying a tax benefit from a transaction that otherwise would meet the requirements of the statute. Where Parliament has not been clear and unambiguous as to its intended policy, the Court cannot make a finding of misuse or abuse, and compliance with the statute must govern.[129]

Turning to the specific provisions themselves, the Court held that the transactions had not misused the specific stop-loss rule that allowed the corporation to transfer the accrued losses to the partnership,[130] but had abused the statutory scheme, which generally prohibits the transfer of losses from one corporation to an unrelated corporation.[131] As a result, the Court applied the GAAR to deny the loss.

(c) ***Mathew*, *Canada Trustco*, and Lower Court GAAR Cases, 2005-2013**

When the Supreme Court of Canada finally ruled on the GAAR in 2005, it released two judgments simultaneously, applying the provision in one case but not in the other.[132] In *Mathew*,[133] which involved the same transactions as *OSFC*, the Court applied the GAAR to disallow the deduction of losses by individual investors who acquired partnership interests from OSFC on the basis that use of the stop-loss rule to transfer accrued losses to any unrelated person was contrary to the purpose of this provision to deny a loss and preserve it "under the assumption that it will be realized by a taxpayer who does not deal at arm's length with the transferor."[134] In

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[128] *Ibid*. at para. 69. Although unstated in the decision, this conclusion is consistent with the language of subsection 245(4) as it read at the time, which provided that the GAAR would not apply to an avoidance transaction where it was reasonable to conclude that the transaction did not result in a misuse or abuse – suggesting that the GAAR would apply only where it was unreasonable to find no misuse or abuse. As noted below, *infra* notes 142-143 and accompanying text, this language was subsequently changed, calling into question the continuing application of this "clear and unambiguous" test.

[129] *Ibid*. at para. 70.

[130] *Ibid*. at paras. 71-81, concluding that the policy of subsection 18(13) was not only to disallow the loss, but to preserve it in the hands of a related transferee. For a critical analysis of this conclusion, see Duff, "Judicial Application of the General Anti-Avoidance Rule in Canada" *supra* note 61, arguing that the Court's singular attention to the text of subsection 18(13) to divine its underlying policy was "extremely limited". The Supreme Court of Canada took a similar view in *Mathew*, *supra* note 80, concluding (at para. 41) that the decision in *OSFC*, *supra* note 69, had interpreted subsection 18(13) "in a literal manner" and (at paras. 53-62) that the transaction resulted in a misuse of this provision.

[131] *Ibid*. at paras. 82-114.

[132] For a detailed discussion of these cases, see David G. Duff, "The Supreme Court of Canada and the General Anti-Avoidance Rule: *Canada Trustco* and *Mathew*" (2006), 60 *Bulletin for International Taxation* 54.

[133] *Supra* note 80.

[134] *Ibid.* at para. 58.

Canada Trustco,[135] which involved a complicated series of circular transactions that allowed the taxpayer to deduct capital cost allowance (CCA) on assets that it acquired at little real economic cost and immediately leased back to the vendor, the Court rejected the Crown's argument that the transactions "contravened the object, spirit or purpose of the CCA regime"[136] on the grounds that these provisions generally allow deductions based on the legal cost of capital assets irrespective of their real economic cost and depart from this rule only in specifically limited circumstances.[137]

While the Court's purposive interpretation of the stop-loss rule in *Mathew* was a welcome correction to the "narrow textual analysis" of this provision in *OSFC*,[138] its unwillingness in *Canada Trustco* to look behind the CCA rules to discern an underlying policy of limiting deductions to the real economic cost of capital assets was an unfortunate departure not only from the purposive approach it adopted in *Mathew*, but also from the more wide-ranging abuse analysis that the Federal Court of Appeal endorsed in *OSFC*. Indeed, although the Court explicitly endorsed a more contextual and purposive approach to the interpretation of tax legislation,[139] it also rejected a broad abuse analysis on the grounds that any "search for an overriding policy" of the *ITA* that is not based on "a unified, textual, contextual and purposive interpretation of the specific provisions" relied upon to obtain a tax benefit would "inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped" and "run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs."[140]

For these reasons, notwithstanding the text of subsection 245(4) which clearly distinguishes between a "misuse of … provisions" and an "abuse having regard to those provisions … read as a whole," the Court concluded that this provision does not contemplate "separate inquiries" as the Federal Court of Appeal had held in *OSFC*, but "requires a single, unified approach to the textual, contextual and purposive interpretation of the specific provisions of the *Income Tax Act* that are relied upon by the taxpayer in order to determine whether there was abusive tax avoidance."[141] As well, despite amendments to subsection 245(4) that replaced the original "double negative" language stipulating that the GAAR did not apply to a transaction where it was reasonable to conclude that the transaction would not result in a misuse or abuse with language providing that the GAAR "applies to a transaction" if "it may reasonably be considered" that it would result in a misuse or abuse,[142] the Court adopted the view of the

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[135] *Supra* note 60.
[136] *Ibid*. at paras. 68 and 70, arguing that the series of transactions misused and abused the CCA regime by "manufactur[ing] a cost for CCA purposes" that did not represent the "real economic cost" of the assets to the taxpayer.
[137] *Ibid*. at paras. 74-76, concluding that the Crown's argument would misconstrue the GAAR by reading into the ITA an "external" concept of "economic substance" without regard to "the specific provisions that are relied upon for the tax benefit."
[138] *Mathew*, *supra* note 80 at para. 42.
[139] *Ibid.* at para. 10, explaining that: "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."
[140] *Ibid*. at paras. 41-42.
[141] *Ibid*. at para. 43.
[142] This amendment was enacted in May 2005, after the Court heard the arguments in *Mathew* and *Canada Trustco*, but before the Court rendered its decisions, but was made retroactive to enactment of the GAAR in 1988.

Federal Court of Appeal in *OSFC* that "the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear."[143]

As a result, although the Court's decisions in *Mathew* and *Canada Trustco* demonstrated a departure from the textualism and formalism that characterized the Court's tax judgments in the 1990s and early 2000s, this change was limited, since the Court was unwilling to engage in a broad analysis of the policy underlying a statutory scheme, limited the scope of the abuse analysis under subsection 245(4) to "the specific provisions" relied upon to obtain a tax benefit, and imposed a high standard of "clear and unambiguous" abuse on the misuse or abuse requirement of the GAAR. Indeed, despite affirming a "textual, contextual and purposive" approach to the interpretation of tax statutes, the Court also observed that the *ITA* is "dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation."[144] Similarly, although recognizing that the GAAR limits the scope of the *Duke of Westminster* principle that taxpayers may "manage their affairs" to minimize taxes payable,[145] the Court also emphasized that the GAAR was not intended to repeal the *Duke of Westminster* principle altogether,[146] but rather to "draw … a line between legitimate tax minimization and abusive tax avoidance,"[147] thereby preserving "predictability, certainty and fairness in Canadian tax law."[148] In these respects, the legacy of textual and formalist statutory interpretation, which the Supreme Court of Canada reaffirmed in the 1990s and early 2000s, continued to influence the Court's interpretation of the GAAR.

Not surprisingly, the decisions in *Matthew* and *Canada Trustco* had a significant impact on lower court decisions involving the GAAR, as courts became much more reluctant to conclude that avoidance transactions were abusive on the basis that they contravened a policy underlying a statutory scheme. In *Evans v. Canada*,[149] for example, where the taxpayer engaged in a series of transactions designed to distribute corporate surpluses with little or no tax, the court dismissed the Crown's argument that the transactions were an abusive "surplus strip" on the grounds that the specific provisions relied upon by the taxpayer operated as intended and "the only basis upon which [it] could uphold the Minister's application of section 245 would be to find that there is some overarching principle of Canadian tax law that requires that corporate distributions must be taxed as dividends" which is "precisely what the Supreme Court of Canada has said we cannot do."[150] In *Collins & Aikman Products Co. v. Canada*,[151] where the taxpayer relied on a gap in Canadian tax rules to carry out a corporate reorganization that allowed it to increase the equity of a Canadian subsidiary and extract over $100 million of corporate surplus

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143 *Canada Trustco*, *supra* note 60 at para. 50.
144 *Ibid.* at para. 13.
145 *Ibid.* at paras. 12-13.
146 *Ibid.* at para. 1.
147 *Ibid.* at para. 16.
148 *Ibid.* at para. 31.
149 [2006] 2 C.T.C. 2009, 2005 D.T.C. 1762 (T.C.C.).
150 *Ibid.* at paras. 29-30. Since the transactions involved the payment of dividends to a partnership of which the only members were the taxpayer's spouse and children, the tax benefit obtained was the result of income-splitting more than surplus-stripping.
151 2009 TCC 299, 2009 D.T.C. 1179, aff'd [2011] 1 C.T.C. 250, 210 D.T.C. 5164 (F.C.A.) [*Collins & Aikman*].

without paying non-resident withholding tax on dividends,[152] the court also dismissed the Crown's argument that the transactions abused a statutory scheme against surplus stripping, concluding instead that the provision on which the taxpayer relied was itself part of the statutory scheme,[153] and that the GAAR cannot be used "to fill in … a possible gap left by Parliament."[154]

Similarly, in *Landrus v. The Queen*,[155] where the taxpayer deducted a loss resulting from the disposition of property from one partnership in which he held an interest to another in which he also held an interest, the court rejected the Crown's argument that the transactions, which were not subject to any of the specific stop-loss rules in the *ITA*, contravened a "general policy" to disallow losses resulting from dispositions of property among related persons and within the same economic unit on the grounds that the specific nature of the various stop-loss rules in the *ITA* did not evidence any such underlying policy, but instead indicated that these rules were exceptions to a general policy to recognize losses on all dispositions.[156] And in *Gwartz v. Canada*,[157] where the taxpayer engaged in a series of transactions designed to circumvent a tax on split-income that was introduced in response to the Supreme Court of Canada decision in *Neuman*,[158] the court dismissed the Crown's argument that the transactions were abusive on the grounds that "a broad policy … against income splitting … has not been recognized,"[159] that the GAAR cannot be used "to deny a tax benefit resulting from a taxpayer's reliance on a previously unnoticed legislative gap,"[160] and that subsequent amendments that closed this legislative gap demonstrated a change in the underlying policy of the provision rather than a confirmation that the transactions were abusive at the time.[161]

(d) Lipson, Copthorne, and Beyond

While these decisions illustrate how the Supreme Court of Canada's initial rulings on the GAAR narrowed the scope of this provision, the Court's subsequent decisions in *Lipson*[162] and

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[152] This gap was plugged in 1998, after the tax years at issue in the case, by ITA paragraph 128.1(1)(c.1) which deems a corporation that immigrates to Canada to have received a dividend equal to the amount by which the fair market value of each share at that time exceeds its paid-up capital.

[153] *Ibid.* at para. 59.

[154] *Ibid.* at para. 109. See also *Lehigh Cement Ltd. v. The Queen*, [2010] 5 C.T.C. 13, 2010 D.T.C. 5081 (F.C.A.), in which the Court dismissed the Crown's argument that a transaction had abusively circumvented a provision imposing non-resident withholding tax on non-arm's length interest payments on the grounds that it was insufficient to assert that "the transaction was not foreseen or … exploits a previously unnoticed legislative gap."

[155] [2009] 1 C.T.C. 2009, 2008 D.T.C. 3583 (T.C.C.), aff'd [2009] 4 C.T.C. 189, 2009 D.T.C. 5085 (F.C.A.).

[156] *Ibid.* at paras. 114-120.

[157] [2013] 4 C.T.C. 2035, 2013 D.T.C. 1122 (T.C.C.) [*Gwartz*].

[158] *Ibid.*

[159] *Ibid.,* at para. 53, citing the Supreme Court of Canada's decision in *Neuman*, *supra* note 97.

[160] *Gwartz*, *ibid.* at para. 42.

[161] *Ibid.* at paras. 70-75, referring to subsections 120.4(4) and (5) which extend the tax on split-income to capital gains realized on non-arm's length disposition of private company shares. Although these amendments were, according to the Department of Finance, intended "to maintain the integrity of the tax on split income regime," the court concluded (at para. 74) that "a reasonable inference can be drawn that Parliament decided not to cover capital gains when the measure was first enacted, and chose to do so on a prospective basis only with respect to a narrow set of capital gains transactions."

[162] *Supra* note 82.

Copthorne[163] appear to have opened the door to the kind of broader policy arguments that the Court dismissed in *Canada Trustco*.

The first of these cases involved a series of transactions in which the taxpayer's spouse deducted interest on borrowed funds that she used to purchase shares of a family company from the taxpayer, who used the proceeds from the sale of the shares to purchase a personal residence. Although the share sale would normally have resulted in a taxable capital gain, the taxpayer relied on a "rollover" rule for transfers of property between spouses and common-law partners to defer tax on the gain,[164] as a consequence of which income attribution rules provide that any income, gain or loss on the transferred shares are attributed to the taxpayer.[165] Since the company paid very little in the way of dividends, the interest expense incurred by the taxpayer's spouse exceeded this income, resulting in a net loss which was attributed to the taxpayer, allowing him to shelter other income from tax.

Emphasizing that "the *Duke of Westminster* principle has never been absolute,"[166] and adding that the standard for establishing that a transaction results in a misuse or abuse is "on the balance of probabilities" (not a "clear and unambiguous" standard),[167] the Court held that the transactions were contrary to the purpose of the income attribution rule since they enabled the taxpayer to reduce his taxes by using a rule that is intended "to prevent spouses from reducing tax by taking advantage of their non-arm's length relationship when transferring property."[168] As a result, the Court concluded:

> … the attribution … that allowed Mr. Lipson to deduct the interest in order to reduce the tax payable on the dividend income from the shares and other income, which he would not have been able to do were Mrs. Lipson dealing with him at arm's length, qualifies as abusive tax avoidance…. Indeed, a specific anti-avoidance rule is being used to facilitate abusive tax avoidance.[169]

In this decision, therefore, the Court applied the GAAR based on a broad interpretation of the policy underlying the relevant statutory provision.

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[163] *Supra* note 61.
[164] ITA, subsection 73(1).
[165] ITA, subsection 74.1(1) and 74.2(1), as well as subsection 74.5(1) which provides that these attribution rules do not apply where property is transferred for proceeds not less than fair market value, unless the taxpayer does not elect out of the rollover rule in subsection 73(1).
[166] *Lipson*, *supra* note 82 at para. 21.
[167] *Ibid.* Although the Court made this comment without any explanation and without any acknowledgement of the "clear and unambiguous" standard adopted in *OSFC* and *Canada Trustco*, this standard is consistent with the amended language of subsection 245(4) which now applies where it is reasonable to conclude that a transaction results in a misuse or abuse..
[168] *Ibid.* at para. 42. The Court might also have questioned whether the transactions were consistent with the purpose of the rollover provision, which is designed to defer tax on transfers of property between spouses and common-law partners, but is arguably inappropriate where a gain is actually realized on a sale for fair market consideration. The Court rightly rejected the Crown's argument that the borrowed funds misused the interest deduction because they were ultimately used to purchase a personal residence, on the basis that the ITA applies to individual taxpayers rather than spouses as a combined tax unit. As a result, as the Court explained, "Mrs. Lipson financed the purchase of income-producing property with debt, whereas Mr. Lipson financed the purchase of the residence with equity." *Ibid.* at para. 41.
[169] *Ibid.* at para. 42.

In *Copthorne*,[170] the Court considered another "surplus stripping" case, involving a series of transactions including an amalgamation of related companies in manner that duplicated the equity or "paid-up capital" (PUC) that had been invested in these companies, which allowed the amalgamated company to distribute corporate surpluses to a non-resident shareholder without paying non-resident withholding tax on dividends. Explaining that "the PUC scheme of the Act" is intended to permit the withdrawal of corporate equity without liability for tax "in recognition of the fact that the initial investment is made with tax-paid funds,"[171] the Court held that a transaction that converted a "vertical" amalgamation of one company and its subsidiary into a "horizontal" amalgamation of two sister companies abusively circumvented a specific provision of the *ITA* that would otherwise have prevented the duplication of each company's paid-up capital.[172] As a result, although the decision was careful to emphasize that this conclusion was based on "an examination of the PUC sections of the Act" not upon "some broad statement of policy, such as anti-surplus stripping, which is not attached to the provisions at issue,"[173] the Court was again prepared to look behind these provisions to discern an underlying policy that the taxpayer's transactions contravened.

While the extent to which these decisions will influence lower court GAAR decisions remains somewhat uncertain, three subsequent cases suggest they have had a discernable impact. In *Gervais v. The Queen*,[174] where the taxpayer gifted some shares to his spouse on a rollover basis and realized a gain on a fair market sale of other identical shares to his spouse, who then realized a gain on the sale of all the shares to an arm's length person that was computed under a specific provision of the *ITA* by averaging the cost of the gifted and purchased shares,[175] the Federal Court of Appeal relied on *Lipson* to conclude that the attribution to the taxpayer of a reduced gain on the gifted shares as a consequence of the cost averaging provision was "contrary to the object, spirit and purpose of [the rollover provision and the attribution rule], the purpose of which is to ensure that a gain (or loss) deferred by reason of a rollover between spouses or common-law partners be attributed back to the transferor."[176]

In *1245989 Alberta Ltd. v. The Queen*,[177] where the taxpayer engaged in a series of transactions that increased the paid-up capital of some shares by averaging them with the paid-up capital of other shares of the same class, allowing him to distribute corporate surpluses without any tax, the Tax Court of Canada relied on *Copthorne* to conclude that the transactions were contrary to "the object, spirit and purpose" of a specific anti-avoidance rule intended "to prevent the removal of taxable corporate surplus as a tax-free return of capital,"[178] as well as the statutory

[170] *Supra* note 61.
[171] *Ibid.* at paras. 91-92.
[172] *Ibid*. at para. 124, referring to ITA, subsection 87(3), which cancels the paid-up capital of a subsidiary on a vertical amalgamation.
[173] *Ibid*. at para. 118. Unfortunately, the Court (at para. 68) also reaffirmed the statement in *Canada Trustco*, *supra* note 60 at para. 50, that "the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear" – thereby ignoring the amended language of subsection 245(4) and the statement in *Lipson, supra* note 82 at para. 21, that the standard for finding an abuse is "on the balance of probabilities."
[174] 2018 FCA 2, 2018 D.T.C. 5005 [*Gervais*].
[175] ITA, subsection 47(1).
[176] *Gervais*, *supra* note 174 at para. 51.
[177] [2017] 4 C.T.C. 2103, 2017 D.T.C. 1026 (T.C.C.).
[178] *Ibid*. at para. 68.

definition of "paid-up capital" which makes specific adjustments to the corporate law concept of stated capital "to ensure that PUC, calculated and averaged within the class, accurately represents and is restricted to the funds invested in the shares of the corporation by its shareholders."[179] Most significantly, the Court emphasized:

> Legislation cannot be drafted that captures all eventualities and particular strategies. In adopting GAAR, Parliament recognized that specific anti-avoidance rules … often proved to be ineffective in curtailing tax avoidance arrangements considered by Parliament to be abusive. Too many routes may be taken by the ingenuity of tax planners to be blocked by specific anti-avoidance rules …. GAAR was adopted to block abusive arrangements, amongst other things, and to close the gaps that sophisticated tax plans seek to exploit as here.[180]

Among other things, the suggestion in this passage that the GAAR can be used to "close … gaps" is strikingly at odds with earlier statements in in *Collins & Aikman*[181] and *Gwartz*[182] that the GAAR cannot be used to fill possible gaps left by Parliament.

Finally, and most significantly, is the Federal Court of Appeal decision in *Triad Gestco Ltd. v. Canada*,[183] which applied the GAAR to deny a capital loss on the grounds that the loss was "a loss on paper only" that was deliberately created by a series of transactions that generated a simultaneous accrued gain that the taxpayer could have deferred indefinitely.[184] Although the Court held that the transactions resulted in "an abuse and misuse" of specific provisions of the *ITA* that defined allowable capital losses for tax purposes,[185] the ultimate basis for the decision appears to be its conclusion that "[t]he result proposed by the appellant is fundamentally counter-intuitive as the capital gain system is generally understood to apply to real gains and real losses."[186] Indeed, the Court described this as an "overarching policy" that applied irrespective of the existence of a former specific anti-avoidance rule that would have denied the loss, which was repealed when the GAAR was enacted on the assumption that the GAAR would "fill the void".[187]

5. Conclusion

The introduction of the Canadian GAAR in 1988 provides a fascinating example of an attempt to legislate a particular approach to statutory interpretation in the context of tax avoidance transactions: a purposive and substantive approach, as opposed to the textual and

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[179] *Ibid.* at para. 55.
[180] *Ibid.* at para. 101.
[181] *Supra* note 151.
[182] *Supra* note 157.
[183] [2013] 1 C.T.C. 202, 2012 D.T.C. 5156 (F.C.A.).
[184] *Ibid.* at para. 39.
[185] *Ibid.* at para. 50, referring to ITA, paragraphs 38(b), 39(1)(b) and 40(1)(b).
[186] *Ibid.* at para. 41, citing the House of Lords decision in *Ramsay*, *supra* note 27.
[187] *Ibid.* at para. 53, referring to former subsection 55(1) of the ITA, which, among other things, disallowed losses resulting from transactions that "artificially" or "unduly" created a loss. According to the Court, "it is not necessary to rely on former subsection 55(1) to decipher the existence of a policy which prevents the deduction of the loss claimed in this case." *Ibid.*

formalist approach that characterized traditional Anglo-Canadian tax jurisprudence. As experience in Canada since 1988 demonstrates, judicial adoption of this approach has been slow and at times limited.

Despite the GAAR, Supreme Court of Canada decisions from 1994 to 2005 were not only unwilling to extend the principles of this new rule to transactions entered into before the provision came into force, but also rejected the more purposive and substantive approach that the Court had embraced in the 1980s and early 1990s – as if enactment of a statutory GAAR confirmed the validity of textualism and formalism, absent the application of this rule. When the Supreme Court finally ruled on the GAAR in 2005, it was reluctant to accept a radically different approach, declaring that the *ITA* is "dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation,"[188] and emphasizing that the GAAR was not intended to repeal the *Duke of Westminster* principle that taxpayers may "manage their affairs" to minimize taxes payable.[189]

As a result, although the decision in *Mathew* demonstrated a willingness to look behind a specific statutory rule to conclude a transaction had misused its purpose, the Court's judgment in *Canada Trustco* limited the scope of the GAAR by rejecting a broad abuse analysis, limiting this analysis to "the specific provisions" relied upon by the taxpayer to obtain a tax benefit, and adopting a "clear and unambiguous" standard for finding an abuse that contradicts the amended text of subsection 245(4) of the *ITA*. The effect of this decision is clearly apparent in subsequent lower court decisions, where courts were reluctant to look behind statutory provisions to find an underlying statutory scheme and unwilling to apply the GAAR to plug unintended legislative gaps that allow for abusive tax avoidance.

In contrast to *Canada Trustco*, the Court's subsequent decisions in *Lipson* and *Copthorne* were more willing to accept the direction of the GAAR, adopting a broad interpretation of the purpose of specific provisions as well as the statutory scheme that these provisions comprise. Although the full effect of these decisions remains to be determined, lower court cases subsequent to these decisions suggest that courts are now more willing to look behind the text of statutory provisions to conclude that a provision or scheme has been abused, more willing to identify a broad policy that transactions may have abused, and more willing to use the GAAR to fill unintended legislative gaps that tax advisors and their clients are otherwise able to exploit. Since this was the objective that Parliament sought when it introduced the GAAR, it appears as though this exercise in legislated statutory interpretation may have been a modest success – though it took almost 30 years.

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[188] *Canada Trustco*, *supra* note 60 at para. 13.
[189] *Ibid*. at para. 1.