
Policy Forum: Defending Against a GAAR Reassessment

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INTRODUCTION

This article discusses strategic considerations in defending against an assessment or reassessment where the general anti-avoidance rule (GAAR) is raised as an issue. We emphasize the importance of knowing (either by notice or by inference) the factual transactions and the specific provisions of the Income Tax Act (Canada)¹ on which the minister intends to base the GAAR reassessment.² Once these are disclosed, the

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

2 The references to GAAR in this article are to section 245 of the Act. The provincial income tax statutes also have general anti-avoidance rules. Given the similarity of the federal and provincial rules, the issues discussed in this article should also apply to provincial GAAR reassessments. See, for example, *Husky Energy Inc. v. Alberta*, 2012 ABCA 231; *Canada Safeway Limited v. Alberta*, 2012 ABCA 232; and *Inter-Leasing, Inc. v. Ontario (Revenue)*, 2013 ONSC 2927.

taxpayer should proactively rebut the minister's attempt to prove the misuse or abuse of specific provisions and ensure that a unified textual, contextual, and purposive interpretation of the provision is made.

Four related topics will be covered in this article:

1. emphasizing that GAAR is a legal test and not a smell test;
2. effectively framing the series of transactions;
3. proactively rebutting the minister's attempt to prove the clear policy of the specific provisions at issue; and
4. mounting a defence to the minister's attempt to prove misuse or abuse of the Act.

The well-known test for the application of GAAR was established by the Supreme Court of Canada in the *Canada Trustco* case.³ The test has three parts. First, there must be a *tax benefit* arising from a transaction or from a series of transactions that includes that transaction.⁴ Second, there must be an *avoidance transaction*, in that the transaction or series of transactions at issue cannot reasonably be considered to have been undertaken or arranged primarily for a bona fide purpose other than to obtain the tax benefit.⁵ Third, there must be *abusive tax avoidance*, in that the transaction is not consistent with the object, spirit, and purpose of the provisions relied on by the taxpayer in obtaining the tax benefit.⁶

Fundamental to defending against a GAAR reassessment is understanding and dealing with the allocation of the burden of proof in respect of the three-part test. The taxpayer has the burden to refute the existence of a tax benefit and an avoidance transaction.⁷ The minister, on the other hand, must establish that the abusive nature of the transaction is clear.⁸ If the existence of abusive tax avoidance is unclear, in that the minister cannot provide clear evidence, the benefit of the doubt goes to the taxpayer.⁹

GAAR—A LEGAL TEST, NOT A SMELL TEST

Even for many tax practitioners, it is tempting to reduce GAAR to a smell test. The courts have repeatedly reminded us to adhere to the legal application of the GAAR test and not to be distracted by any moral or normative considerations divorced from a rigorous interpretation of the transactions and provisions at issue.

3 *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, at paragraph 66.

4 Subsection 245(1), the definition of "tax benefit," and subsection 245(2).

5 Subsections 245(2) and (3).

6 Subsection 245(4).

7 *Canada Trustco*, supra note 3, at paragraph 63.

8 *Ibid.*, at paragraph 65.

9 *Ibid.*, at paragraphs 62 and 66.

In *Jabs Construction*, a pre-*Canada Trustco* case, Bowman J commented that GAAR is an extreme sanction that “should not be used routinely every time the Minister gets upset just because a taxpayer structures a transaction in a tax effective way, or does not structure it in a manner that maximizes the tax.”¹⁰ Years later in *XCO Investments*, Bowman J reiterated that anti-avoidance provisions are

not intended as a means of punishment for offending the Minister’s olfactory sense. They do not give the Minister carte blanche to impose sanctions for transcending his notion of fiscal rectitude.¹¹

In *Coptborne*,¹² the Supreme Court emphasized the importance of applying GAAR as a legal test and reiterated the taxpayer’s right to non-abusive tax planning. The Supreme Court said:

The terms “abuse” or “misuse” might be viewed as implying moral opprobrium regarding the actions of a taxpayer to minimize tax liability utilizing the provisions of the *Income Tax Act* in a creative way. That would be inappropriate. Taxpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability (see *Duke of Westminster*).¹³

The Supreme Court in *Coptborne* reminded the lower courts—and the Canada Revenue Agency (CRA)—why a rigorous application of GAAR is important:

A court must be mindful that a decision supporting a GAAR assessment in a particular case may have implications for innumerable “everyday” transactions of taxpayers. . . . [b]ecause of the potential to affect so many transactions, the court must approach a GAAR decision cautiously. . . .

For this reason, “the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear” (*Trustco*, at para. 50). The court’s role must therefore be to conduct an objective, thorough and step-by-step analysis and explain the reasons for its conclusion.¹⁴

Tax practitioners have an important role to play in ensuring that a thorough and objective standard is consistently applied in the handling of GAAR cases, starting with the audit or proposal letter. Nonetheless, it must be recognized that transactions or plans that are “smelly” do inherently raise the litigation risk and reputational risk for taxpayers. Accordingly, when considering a proposed transaction, tax practitioners

10 *Jabs Construction Ltd. v. R*, 99 DTC 729, at paragraph 48.

11 *XCO Investments Ltd. v. The Queen*, 2005 TCC 655, at paragraph 40; aff’d. 2007 FCA 53. Bowman J was referring to “anti-avoidance sections such as 103 and 245.” He also noted that where a specific anti-avoidance provision covers a transaction but does not provide an adequate remedy, GAAR is not there to allow the minister to top up the remedy that the minister believes inadequate.

12 *Coptborne Holdings Ltd. v. Canada*, 2011 SCC 63.

13 *Ibid.*, at paragraph 65.

14 *Ibid.*, at paragraphs 67–68.

should take into account the potential risk of a future GAAR reassessment and tax litigation arising from the transaction. Often, this means that the GAAR analysis should be done in the early planning phases.

FRAMING THE SERIES OF TRANSACTIONS: TAX BENEFIT AND AVOIDANCE TRANSACTION

Although practice and the jurisprudence since *Canada Trustco* have shown that the case for applying GAAR will often ultimately be determined at the misuse or abuse stage of the GAAR analysis, it is important not to concede too quickly the existence of a tax benefit and an avoidance transaction, and to ensure that the first two parts of the GAAR analysis are thoroughly considered.

Where there is a series of transactions, all three parts of the GAAR analysis are implicated, in that for GAAR to apply, the series of transactions must result in a tax benefit,¹⁵ and there must be at least one transaction in the series that can reasonably be considered to be an abusive avoidance transaction.¹⁶ Accordingly, tax practitioners should not ignore the framing of the series of transactions, nor should they necessarily accept the minister's proposals (at the audit and objection stages) or the factual assumptions (at the court stage) relating to the series of transactions.

The Supreme Court in *Coptborne* gave a broad meaning to "series of transactions," noting that the statutory definition in subsection 248(1) expands the common-law meaning. The court explained that, whereas the common-law definition of a series requires that "each transaction in the series [is] pre-ordained to produce a final result," subsection 248(10) goes further by deeming "any related transactions or events completed in contemplation of" a series to be part of that series.¹⁷

Under the expanded meaning, for a transaction to be part of a series, the series must have been taken into account when the decision was made to undertake the related transaction, in the sense that that transaction was undertaken "in relation to" or "because of" the series.¹⁸ On the basis of *Coptborne*, it is clear that the statutory series allows either a prospective or a retrospective connection of a transaction related to a common-law series.¹⁹

15 As defined in subsection 245(1).

16 Reading subsections 245(3) and (4) conjunctively.

17 *Coptborne*, supra note 12, at paragraph 43 (citing the common-law definition of "series" in *OSFC Holdings Ltd. v. Canada*, 2001 FCA 260, at paragraph 24).

18 *Coptborne*, supra note 12, at paragraph 47: "Although the 'because of' or 'in relation to' test does not require a 'strong nexus,' it does require more than a 'mere possibility' or a connection with 'an extreme degree of remoteness.'" The length of time, and any intervening events between the series and the related transaction, are also relevant to the analysis.

19 *Ibid.*, at paragraph 56. This interpretation of subsection 248(10) appears to be inconsistent with the French version of subsection 248(10), which contemplates that the transaction to be added to the common-law series must be subsequent to the transaction to be added under subsection 248(10). See Alan M. Schwartz, *GAAR Interpreted: The General Anti-Avoidance Rule* (Toronto: Carswell) (looseleaf), 5-434.2.

The key to establishing the series of transactions is the availability of evidence showing the motivations behind the transactions, since it is the taxpayer's onus to rebut any assumptions made by the minister. Contemporaneous documentation of a non-tax rationale, if any, should be retained at the planning stages in order to assist in the future defence against a GAAR reassessment. However, taxpayers should be careful not to provide a road map or to waive privilege, if applicable, in providing such documents.

Taxpayers have generally been unsuccessful in rebutting the existence of a tax benefit,²⁰ and slightly more successful in rebutting the existence of an avoidance transaction.²¹ *Univar*²² is the lone case in which the Tax Court found no tax benefit. As the Supreme Court noted in *Canada Trustco*, the existence of a tax benefit is clear where a deduction is claimed.²³ In situations where no deduction is claimed or where it is otherwise not clear that there is a tax benefit, the tax benefit can only be established by comparison with an alternative arrangement.²⁴ Under the comparative approach, the alternative arrangement must be one that "might reasonably have been carried out but for the existence of a tax benefit."²⁵

In light of the Supreme Court's statement regarding the existence of a tax benefit, a tax deduction appears to be a tax benefit even where the deduction offsets an income inclusion. For example, a subsection 112(1) deduction that offsets an income inclusion under subparagraph 82(1)(a)(i) or (a.1)(i) in respect of a dividend receipt appears to be considered a tax benefit under the Supreme Court's guidance. However, we suggest that this is one example of a situation where the comparative approach should be applied.²⁶ We suspect that this will be an area of dispute in the future.

There are at least three recent cases in which the court found no avoidance transaction: *Spruce Credit Union*,²⁷ *McClarty*,²⁸ and *Swirsky*.²⁹

20 Jinyan Li and Thaddeus Hwong, "GAAR in Action: An Empirical Exploration of Tax Court of Canada Cases (1997-2009) and Judicial Decision Making" (2013) 61:2 *Canadian Tax Journal* 321-66, at 348.

21 *Ibid.*, at 350-51.

22 *Univar Canada Ltd. v. The Queen*, 2005 TCC 723.

23 *Canada Trustco*, *supra* note 3, at paragraph 20.

24 In *Univar*, *supra* note 22, at paragraphs 42-44, Bell J compared the subject transaction with an alternative arrangement and concluded (*ibid.*, at paragraph 42) that, on the basis of the evidence, it was clear that the taxpayer never would have entered into an alternative transaction.

25 *Coptborne*, *supra* note 12, at paragraph 35 (citing David G. Duff, Benjamin Alarie, Kim Brooks, and Lisa Philipps, *Canadian Income Tax Law*, 3d ed. (Toronto: LexisNexis Butterworths, 2009), at 187).

26 In *Spruce Credit Union v. The Queen*, 2012 TCC 357, at issue was a section 112 dividend deduction, and the tax benefit issue was conceded.

27 *Ibid.*

28 *McClarty Family Trust v. The Queen*, 2012 TCC 80.

29 *Swirsky v. The Queen*, 2013 TCC 73.

In *Spruce Credit Union*, the Tax Court affirmed that a transaction, or a step in a series of transactions, will be an avoidance transaction if it is undertaken or inserted primarily for tax purposes. According to the court, in *Spruce Credit Union* the overall transactions had a non-tax purpose, and, in contrast to the facts in *Coptborne*, no step was inserted or undertaken primarily for tax purposes.³⁰ The court noted:

The act of choosing or deciding between or among alternative available transactions or structures to accomplish a non-tax purpose, based in whole or in part upon the differing tax results of each, is not a transaction. Making a decision cannot be an avoidance transaction.³¹

This case reinforces the concept that a transaction in a series of transactions that reduces tax is not necessarily an avoidance transaction. For example, the insertion of a section 85 election step would not necessarily be an avoidance transaction even though the purpose of a section 85 rollover is clearly to defer tax. If the taxpayer has a non-tax reason to contribute assets to a corporation, the taxpayer is entitled to choose to do so in a way that minimizes tax.

In *McClarty*, the Tax Court found that there was no avoidance transaction, noting that every single transaction in the series had a bona fide purpose. The primary motivating element of the transactions at issue was the intention to protect assets.³²

Similarly, in *Swirsky*, the Tax Court found that there was no avoidance transaction.³³ In that case, there was evidence that the taxpayer was concerned about liability owing to the real estate downturn and followed a creditor-proofing plan provided by his adviser. The case was also unusual in that the minister had the burden of proving the existence of an avoidance transaction because the issue was raised in reply.

Another interesting aspect of *Swirsky* is that the minister argued that the transactions could not have creditor-proofing as a non-tax purpose because the transactions were not effective in providing creditor-proofing. Although the Tax Court ultimately found that the minister was unable to prove that the transactions did not achieve the creditor-proofing purpose, it should not have been necessary for the non-tax purpose to have been effective. There must be intention, and the transactions, of course, cannot be a sham, but the non-tax purpose should not necessarily have to have been successful, since it is the taxpayer's intention that should matter.

The above cases indicate that an argument can be made that no avoidance transaction exists where a transaction, or a series of transactions, is initiated in response to an external change in the commercial or regulatory environment of the business.³⁴

30 *Spruce Credit Union*, supra note 26, at paragraph 92.

31 *Ibid.*, at paragraph 93.

32 *McClarty*, supra note 28, at paragraph 53.

33 *Swirsky*, supra note 29.

34 That is, a non-tax-related external change. In *Coptborne*, supra note 12, at paragraph 48, the Tax Court judge was aware of the intervening introduction of a change in the foreign accrual

Contemporaneous documentation that can provide evidence of this external purpose will be helpful in rebutting the existence of an avoidance transaction.

Times of financial stress, compliance with directives from regulators, and arm's-length acquisitions³⁵ all provide opportunities for tax planning, since taxpayers are entitled to minimize the taxes arising from the execution of these transactions. This is a fundamental principle established in the *Duke of Westminster* case.³⁶

PROACTIVELY REBUTTING THE MINISTER'S ATTEMPTS TO PROVE A CLEAR POLICY

The minister has the burden to prove abusive tax avoidance because the minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions relevant to the transactions at issue.³⁷ The minister is required to identify the object, spirit, or purpose of the provisions that are alleged to have been abused; to set out the policy with reference to those provisions; and to identify the extrinsic aids relied upon.³⁸ For this reason, in defending against a GAAR reassessment, the taxpayer should try to obtain the minister's audit or reassessment position with respect to the misuse or abuse analysis as early as possible, including the specific provisions relied on or that will be relied on by the minister.

In *Birchcliff*,³⁹ the Tax Court granted a motion by the taxpayer demanding that the minister disclose the tax policy that the CRA relied on in reassessing the taxpayer under GAAR. This decision supports the principle that a taxpayer is entitled to early disclosure of tax policy so that the taxpayer may properly respond to the allegations of the minister, especially in a GAAR reassessment. We submit that this principle should be extended to the proposal letter stage, so that taxpayers have an early chance to respond to the minister's concerns after an audit.⁴⁰

property income rules and the time interval between the transactions, and yet he still found a "strong nexus" between the series and the subsequent share redemption. This determination was upheld by both the Federal Court of Appeal and the Supreme Court of Canada.

35 Rothstein J noted in *Coptborne*, supra note 12, at paragraph 120, that whether transactions are between parties dealing at arm's length or not at arm's length should be immaterial in determining whether there is an avoidance transaction.

36 *IRC v. Duke of Westminster* (1936), 19 TC 490 (HL).

37 *Canada Trustco*, supra note 3, at paragraph 65.

38 *Ibid.*, at paragraph 64.

39 *Birchcliff Energy Ltd v. R.*, [2013] 3 CTC 2169.

40 Access to tax policy information earlier in the tax dispute resolution process would also promote settlement and the narrowing of issues. At the administrative stage of the dispute resolution process (that is, at audit or on the filing of a notice of objection), a taxpayer has a limited ability to require that the minister show his or her case. There are no pleadings and no discovery process at this stage. Although the taxpayer may receive an audit proposal letter, there is no requirement for the CRA to provide it. Earlier access to tax policy information allows the parties to reasonably and fairly address issues on the basis of complete information.

There is also a broader principle supporting the taxpayer's entitlement to know the minister's view as to the policy of the various provisions in the Act. Because the Canadian tax system is a self-assessment system, it is important that taxpayers be able to determine the tax consequences of proposed transactions before they are implemented, including whether GAAR might apply.⁴¹

Evidence of Clear Policy

In *Canada Trustco*, the Supreme Court stated that in determining the object, spirit, or purpose of a provision, one can refer to "permissible extrinsic aids."⁴² The Supreme Court did not articulate what were permissible extrinsic aids, although it did refer extensively to the Department of Finance explanatory notes. Presumably, Hansard, budget papers, and statements of the minister of finance would be permissible.

We propose that permissible extrinsic aids be given a broad meaning. As Rothstein J noted in *Copthorne*,

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.⁴³

Rothstein J further noted that while the textual, contextual, and purposive approach is the same as in other non-GAAR cases, the analysis seeks to determine a different aspect of the statute. Rather than determining the meaning of the statute, the GAAR analysis requires a search for "the rationale that underlies the words that may not be captured by the bare meaning of the words themselves."⁴⁴

This suggests to us that the extrinsic evidence supporting the GAAR analysis should be broader than that normally used to interpret or discern the meaning of statutes or other provisions of the Act. Such evidence includes contemporaneous documents indicating what the government policy makers and legislative drafters were considering at the time the provisions were drafted and introduced. We also

41 However, in *STB Holdings Ltd. v. The Queen*, 2002 FCA 386, the Federal Court of Appeal noted that a taxpayer cannot self-assess under GAAR in filing its tax return. The Court of Appeal agreed with Miller J of the Tax Court of Canada when he said that GAAR is not a planning tool for the taxpayer, and the taxpayer cannot apply GAAR to itself in filing its return (*ibid.*, at paragraphs 11-13). In *Copthorne Holdings Ltd. v. The Queen*, 2007 TCC 481, at paragraphs 77-78, Campbell J confirmed that even if GAAR is applicable to a transaction or a series of transactions, there was no basis or ground for the imposition by the minister of penalties, let alone gross negligence penalties, given that (1) the taxpayer had no ability in filing its tax return to self-assess or apply GAAR, and (2) the fact that the minister needed to resort to the application of GAAR was evidence that the taxpayer had, in filing its return, strictly complied with the letter of the law.

42 *Canada Trustco*, *supra* note 3, at paragraph 55.

43 *Copthorne*, *supra* note 12, at paragraph 66.

44 *Ibid.*, at paragraph 70.

suggest that extrinsic evidence should be broader than the “official policy” set out in the technical notes and could, for example, include the policy choices not to do certain things. Given the “unusual duty” that the GAAR analysis places on the courts (and therefore on taxpayers considering proposed transactions), and given the complex policy arguments that must inform the misuse and abuse stage of that analysis, this broad view of the permissible extrinsic aids is in our view necessary. We expect that this too will be an area of dispute in the future.

The Meaning of “Clear”

As noted earlier, in *Canada Trustco* the Supreme Court said that if the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.⁴⁵ In *Lipson*, LeBel J stated that the minister continues to bear the burden of proving on a balance of probabilities that the avoidance transaction results in a misuse or abuse within the meaning of subsection 245(4).⁴⁶ In *Coptborne*, Rothstein J repeated that “the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear.”⁴⁷

Taking these statements together, the Supreme Court is confirming that the legal burden of proof as regards abuse and misuse is on the minister, and the civil standard of balance of probabilities applies. However, the civil standard can require greater clearness of proof. In such cases, the trier of fact should carefully scrutinize the evidence.⁴⁸

Even though the onus is on the minister to prove a clear policy, taxpayers should proactively rebut the minister’s evidence regarding the policy of the provisions at issue. One way to do so is by providing evidence of an alternate policy, or evidence that there was no policy, as opposed to that alleged by the minister.

As noted above, the limits of what constitutes “permissible extrinsic aids” have yet to be settled. Nonetheless, as we have argued, a broad range of materials should inform the debate. These would include, in addition to policy papers and technical notes, other publicly available documents such as government commission reports, textbooks, and academic papers.

Access-to-Information or Freedom-of-Information Requests

We have stated above that it is important to obtain at an early stage the minister’s view of the transaction or series of transactions at issue, the specific provisions of the Act allegedly abused, and the policy underlying those provisions.

45 *Canada Trustco*, supra note 3, at paragraph 66.

46 *Lipson v. Canada*, 2009 SCC 1, at paragraph 21.

47 *Coptborne*, supra note 12, at paragraph 68 (quoting *Canada Trustco*, supra note 3, at paragraph 50).

48 John Sopinka, Sidney N. Lederman, and Alan Bryant, *The Law of Evidence in Canada*, 2d ed. (Toronto: Butterworths, 1999), at 157-59.

One strategy that taxpayers may find useful is making a request for information from the CRA or the Department of Finance. A request can be made for the taxpayer's own information either informally or pursuant to the Privacy Act⁴⁹ (for individuals) or the Access to Information Act⁵⁰ (for corporations).⁵¹ An access-to-information request can also be made for government manuals.⁵²

Taxpayers can also try to ask for records related to the policy of specific provisions of the Act and with respect to certain types of transactions. A request can be made for the records related to the taxpayer's file or the general policy with respect to specific provisions. There are exemptions and exclusions from disclosure such as solicitor-client privilege, "advice or recommendations," and third-party information. However, these exceptions and exclusions should be interpreted in a limited and specific way.⁵³

The identity of the requester and the reasons for the request are generally irrelevant in access-to-information and freedom-of-information legislation in Canada. In particular, where the taxpayer is considering entering into a transaction where there may be a risk of a GAAR reassessment, the taxpayer should be entitled to access information about the tax policy of the specific provisions at issue. Such information is necessary for taxpayers to properly determine the tax consequences of transactions and is consonant with tax certainty, predictability, and fairness.

The scope of the policy information available to taxpayers and other Canadians is an evolving area of law. Early access to policy information is consistent with the scheme of the Act, GAAR, and the self-assessment tax system in Canada.

MOUNTING A DEFENCE TO THE MINISTER'S ATTEMPT TO PROVE MISUSE OR ABUSE

The misuse or abuse stage of the GAAR analysis has two parts. First, the object, spirit, and purpose of the specific provisions allegedly abused must be determined. Second, the transactions must be shown to frustrate the identified purpose.⁵⁴ The minister must clearly demonstrate that the transaction is an abuse of the Act. The GAAR jurisprudence indicates limits to how the minister can prove misuse or abuse.

49 RSC 1985, c. P-21, as amended.

50 RSC 1985, c. A-1, as amended.

51 See paragraph 241(5)(a) of the Act. Taxpayers should consider requesting the CRA Audit Report (T20) and the CRA Appeals Report (T401).

52 Canada Revenue Agency, "The CRA's Information Holdings," CRA website, June 27, 2013 (www.cra-arc.gc.ca/gncy/tp/nfsrc-eng.html). Readers may also want to check their local CRA reading room.

53 *Canadian Council of Christian Charities v. Canada (Minister of Finance)*, [1999] 3 CTC 123, at paragraph 15 (FCTD). See also *Ontario (Finance) v. Ontario (Information and Privacy Commissioner)*, 2012 ONCA 125.

54 *Copthorne*, supra note 12, at paragraphs 69-71.

In *Hill*, a pre-*Canada Trustco* case, the Tax Court held that the minister had failed to identify a policy, stating that the minister must do more than recite the words of the Act.⁵⁵ In proving a clear policy, the minister cannot search for an overriding policy that is not based on a unified textual, contextual, and purposive interpretation of the specific provisions at issue. Furthermore, the series of transactions cannot be recharacterized to fit a policy, nor can the minister rely on the policy of unrelated provisions or transactions.⁵⁶ The recharacterization may come afterward as a remedy, but only after the misuse or abuse is proven (that is, after it has been determined that GAAR applies).⁵⁷

In *Howe*, the Tax Court rejected the GAAR reassessment, stating that the transactions could not be collapsed into a share purchase either on the basis of an economic substance analysis or on the basis of GAAR.⁵⁸ Citing an earlier decision by the Federal Court of Appeal in another case involving the recharacterization of transactions, the Tax Court agreed that “a transaction cannot be portrayed as something which it is not.”⁵⁹

In *Imperial Oil*,⁶⁰ the Federal Court of Appeal indicated that when undertaking the misuse or abuse analysis, a court should also consider provisions related to the one on which the taxpayer specifically relies. The court noted that for GAAR to apply in that case, the minister must show that the provisions relating to the investment allowance had been misused, by demonstrating that the loan at issue was structured so as to defeat a clear and unambiguous policy underlying subsection 181.2(4).⁶¹

Although, in *Imperial Oil*, the Court of Appeal discussed at length the general policy in respect of the part I.3 tax on large corporations, the court noted that the general statutory objectives were only of peripheral relevance and provided only the broader context for determining whether the loan at issue constituted a misuse for the purposes of the GAAR analysis. The court also noted that the CRA had not identified any clear legislative policy underlying the investment allowance provisions. As to the CRA’s views regarding the application of GAAR, as set out in administrative publications and at tax conferences, the court observed that they were only views, and did not carry any special weight with respect to the interpretation or application of the Act.⁶²

55 *Hill v. The Queen*, 2002 DTC 1749, at paragraph 60.

56 *Canada Trustco*, supra note 3, at paragraph 59.

57 Subsection 245(5).

58 *Howe v. The Queen*, 2004 TCC 719, at paragraph 29. See also *McMullen v. The Queen*, 2007 TCC 16, at paragraph 47 (discussed in the text below at note 89 and following).

59 *Ibid.* (quoting from comments by the Federal Court of Appeal in *The Queen v. Canadian Pacific Limited*, 2002 DTC 6742).

60 *Canada v. Imperial Oil Ltd.*, 2004 FCA 36.

61 *Ibid.*, at paragraph 60.

62 *Ibid.*, at paragraph 64.

In practice, this means that the minister's asserted relevant policy must actually have application to the transaction or series of transactions at issue. We discuss below specific cases that illustrate the challenge of identifying an overarching policy.

Stop-Loss Provisions

The courts have found that there is no general unexpressed policy regarding the stop-loss provisions, but appear to have expressed a general policy regarding business losses.

At issue in *Landrus*⁶³ were the terminal loss provisions in subsection 20(16) and various stop-loss rules. The minister conceded that there is no express restriction in subsection 20(16) on claiming a terminal loss where both the transferor and the transferee of the depreciable property are partnerships and all the members of the transferor partnership are members of the transferee partnership.

In the GAAR reassessment, the minister submitted that the stop-loss provisions in subparagraph 40(2)(g)(i), subsection 85(4), paragraph 40(2)(e), and subsection 85(5.1) are part of the legislative context of subsection 20(16) and are relevant to the misuse and abuse analysis. However, the Court of Appeal found that the minister had overstated the extent and the comprehensiveness of the policy underlying these stop-loss provisions. The court found that the precisely drafted rules set out detailed conditions for the denial of a loss that would otherwise arise on the disposition of a particular type of property.

It was important that one variation among the various stop-loss rules was the degree of connection or relationship required, since certain stop-loss rules were driven by the relationship between the parties to the transactions and others were not. The Court of Appeal noted that the specific relationships indicate that the rules are exceptions to a general policy of allowing losses in respect of dispositions. The court concluded that the minister had not shown that there is a general or overall policy in the Act prohibiting losses on any transfer between related parties or parties described as forming an economic unit.

1207192 Ontario,⁶⁴ *Triad Gestco*,⁶⁵ and *Global Equity*⁶⁶ are a trilogy of cases involving stock dividends that shifted value from common shares to preferred shares and thereby gave rise to a loss on the common shares.

In the first two cases, the minister relied on the specific capital loss rule in subparagraph 40(2)(g)(i) and the superficial loss rule in section 54. *Landrus* was distinguished on the basis that there was real economic loss in that case. The Tax Court in *Triad Gestco* went on to say that a contextual and purposive interpretation discloses that

63 *Canada v. Landrus*, 2009 FCA 113.

64 *1207192 Ontario Limited v. The Queen*, 2011 TCC 383.

65 *Triad Gestco Ltd. v. The Queen*, 2011 TCC 259.

66 *Canada v. Global Equity Fund Ltd.*, 2012 FCA 272.

the object, spirit, and purpose of the relevant provisions were to allow only the recognition of “true capital losses incurred outside the same economic unit.”⁶⁷

The *Global Equity* case was different from the other two in the trilogy, in that business losses were at issue. The Federal Court of Appeal did find an overall policy related to business losses. The court held that the minister could not rely on provisions of the Act relating to capital losses in order to ascertain the object, spirit, and purpose of the relevant provisions since the specific provisions at issue concerned the use of business losses, not capital losses. The capital loss provisions are distinct and usually operate independently from one another. The court stated that the minister’s approach “would send this Court on the search for an overreaching policy to override the wording of the provisions of the Act, and it would inappropriately place the formulation of taxation policy in the hands of this Court.”⁶⁸

The court focused on sections 3, 4, 9, and 11, noting that since the key expressions “income,” “profit,” and “loss” used in those sections remain undefined, “GAAR . . . should not be used to impute a special overarching meaning to these expressions.”⁶⁹ In the end, the court did find that the fundamental rationale underlying the provisions at issue is that for business losses to be deductible, the losses “must be grounded in some form of economic or business reality.”⁷⁰

One way to reconcile *Landrus* and the trilogy of loss cases is that courts have been reluctant to apply GAAR in cases where there are specific and detailed rules dealing with the transactions in question. On the other hand, the statement by the Court of Appeal in *Global Equity* regarding “economic or business reality” appears to be a departure from the Supreme Court of Canada’s clear guidance against using an economic substance test.⁷¹

Income Splitting

It is less clear whether there is an overarching purpose against income splitting. In *Overs*,⁷² the Tax Court concluded, in brief reasons, that the transactions were not abusive tax avoidance. The taxpayer had relied on the attribution rules in subsection 74.1(1) to claim a loss in respect of interest incurred on borrowed money. The minister alleged that there was a misuse of subsection 74.1(1), among other provisions. Subsection 74.1(1) prevents income splitting among family members but is not intended to allow the deduction of interest and other personal expenses. The minister also alleged that the transactions constituted an abuse of the Act as a whole.

67 *Triad Gestco*, supra note 65, at paragraph 55.

68 *Global Equity*, supra note 66, at paragraph 52.

69 *Ibid.*, at paragraph 59.

70 *Ibid.*, at paragraph 62.

71 *Canada Trustco*, supra note 3, at paragraph 57.

72 *Overs v. The Queen*, 2006 TCC 26.

The Tax Court referred to *Canada Trustco* regarding the minister's onus to establish that the avoidance transaction frustrates or defeats the purpose for which the tax benefit was intended, and concluded, on the basis of the evidence, that none of the transactions were "abusive tax avoidance" transactions.⁷³ *Overs* is an early GAAR judgment that appears to have been overruled by *Lipson*.

In *Lipson*, at issue were subsection 73(1) and the attribution rules in subsections 74.1(1) and 74.2(1). The Supreme Court was strongly divided, and three separate opinions were issued. LeBel J, writing for the majority, noted that "the effect of s. 73(1) is to facilitate interspousal transfers of property without triggering immediate tax consequences."⁷⁴ However, the attribution rules in sections 74.1 through 74.5 are anti-avoidance provisions, the purpose of which is to prevent spouses and other related persons from reducing tax by taking advantage of their non-arm's-length status when transferring property between them. LeBel J noted that it was strange that subsection 74.1(1) could result in a reduction of the total amount of tax payable on the income of the transferred property.⁷⁵ He concluded that the taxpayers' use of the provision in this way qualified as abusive tax avoidance⁷⁶ but provided little analysis of the specific policy behind the provision. The majority appeared not to approve of the fact that a specific anti-avoidance rule was being used to facilitate abusive tax avoidance.

Binnie J (with Deschamps J concurring) thought that the minister had not shown that the abusive nature of the transactions was clear. He appeared to disagree with the minister's "selective view" that subsection 74.1(1) could attribute net dividend income to increase tax payable by the taxpayer, but that it was abusive for subsection 74.1(1) to be used to attribute losses to the taxpayer, even though subsection 74.1(1) itself draws no distinction between income and losses and even though the income and losses were associated with the same transferred shares.⁷⁷

Binnie J felt that the minister's argument "[painted] with too broad a brush" and failed to identify a specific policy shown to be frustrated by the taxpayer.⁷⁸ He reiterated that it was not for the courts to search for an overriding policy and use such a policy to override the wording of the provisions of the Act. This, again, would run counter to the principles of certainty, predictability, and fairness.⁷⁹

In *Swirsky*, Paris J noted in obiter that he would have great difficulty in distinguishing the case before him from *Lipson*, presumably affirming that the transactions

73 Ibid., at paragraphs 23-24 (citing *Canada Trustco*, supra note 3, at paragraph 52).

74 *Lipson*, supra note 46, at paragraph 31.

75 Ibid., at paragraph 42.

76 Ibid., at paragraph 48.

77 Ibid., at paragraph 62.

78 Ibid., at paragraph 65.

79 Ibid., at paragraph 67.

in that case would be considered a misuse of subsection 74.1(1).⁸⁰ In *Gwartz*, the Tax Court stated that there is no broad policy in the Act against income splitting.⁸¹

Dividend Stripping/Surplus Stripping

The practice of dividend stripping or surplus stripping has been a source of dispute between taxpayers and tax authorities for many years.⁸² It is therefore not surprising that a large number of GAAR cases are surplus-stripping cases.⁸³ Despite this activity and the concern of the tax authorities, the courts have found that there is no overarching policy against surplus stripping.

Before the Supreme Court's decision in *Canada Trustco*, the Tax Court found an overarching policy against surplus stripping in two cases, *McNichol*⁸⁴ and *RMM Canadian Enterprises*.⁸⁵ However, in *Geransky*, Bowman J (who had also decided *RMM Canadian*) noted that jurisprudence under section 245 should develop on a case-by-case basis and found that the transactions did not result in a misuse or abuse of the provisions of the Act.⁸⁶ Bowman J stated that where a taxpayer has applied the provisions of the Act and has managed to avoid the pitfalls, the minister cannot say that because the taxpayer avoided the shoals and the traps of the Act, and did not carry out the commercial transaction in a manner that maximized tax, GAAR is to be used to fill in the gaps.⁸⁷

Other cases since *Canada Trustco* diverge further from the earlier cases. In *Evans*, Bowman J declined to find a misuse or abuse, stating:

The only basis upon which I 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 to shareholders must be taxed as dividends, and where they are not the Minister is permitted to ignore half a dozen specific sections of the Act. This is precisely what the Supreme Court of Canada has said we cannot do.⁸⁸

80 *Swirsky*, supra note 29, at paragraph 75. The Tax Court did not need to consider the misuse or abuse question since the minister failed to show that the transactions at issue were avoidance transactions. Paris J also noted, *ibid.*, that while the facts in *Swirsky* were similar to those in *Overs*, the decision in *Overs* "has been implicitly overruled" by *Lipson*. In addition, Paris J found that subsection 74.5(11) did not apply, noting that the dissent by Rothstein J in *Lipson* (supra note 46, at paragraph 102) did not preclude a court from considering GAAR where a specific provision might also apply: *Swirsky*, supra note 29, at paragraph 65.

81 *Gwartz v. The Queen*, 2013 TCC 86, at paragraph 53.

82 H. Heward Stikeman and Robert Couzin, "Surplus Stripping" (1995) 43:5 *Canadian Tax Journal* 1844-60.

83 Paul Hickey, "CRA's GAAR Update" (2013) 21:1 *Canadian Tax Highlights* 3-4 (citing GAAR statistics provided by the CRA at the Canadian Tax Foundation's 2012 annual conference).

84 *McNichol v. The Queen*, 97 DTC 111 (TCC).

85 *RMM Canadian Enterprises v. The Queen*, 97 DTC 302 (TCC).

86 *Geransky v. The Queen*, 2001 DTC 243, at paragraphs 27 and 37-40 (TCC).

87 *Ibid.*, at paragraph 42.

88 *Evans v. The Queen*, 2005 TCC 684, at paragraph 30.

In *McMullen*,⁸⁹ the Tax Court referred to the above paragraph in *Evans* and held that the transactions at issue did not

defeat or frustrate the object, purpose or spirit of any of the provisions of the Act. Those transactions do not lack economic substance. They were real and had legal effect. They were not shams. There was a genuine change in the legal and economic relationships between the two former shareholders.⁹⁰

The Tax Court concluded that the minister had not persuaded the court, or presented any evidence establishing, that there was any abuse of the Act read as a whole, or that the policy of the Act read as a whole is designed so as to necessarily tax corporate distributions as dividends in the hands of shareholders.⁹¹

Similarly, in *Desmarais*,⁹² the Tax Court acknowledged that the specific provisions at issue must be interpreted in their legislative context, together with other related and relevant provisions, in light of the purposes that are promoted by those provisions and their statutory schemes. The Tax Court also acknowledged the minister's argument that there was an abuse of the Act read as a whole, "especially of its rules designed to tax in the hands of the company's shareholders any distribution of its surpluses and its rules designed to prevent a company from having its surplus stripped"⁹³ (referring, in particular, to sections 84, 84.1, and 212.1 and subsection 85(2.1)). In the end, however, the Tax Court focused on a unified textual, contextual, and purposive analysis of the specific provision in section 84.1.

It is difficult to reconcile the finding in *Desmarais* with that of Bowman J in *Evans*. As noted above, Bowman J found no overarching principle of Canadian tax law that requires that corporate distributions to shareholders be taxed as dividends. It should be noted, though, that the court in *Desmarais* did focus specifically on section 84.1 despite its earlier comments on an abuse of the Act read as a whole.

Nonetheless, as a result of the Supreme Court's decision in *Copthorne*, it is settled that there is no overarching policy on surplus stripping. As the court stated,

Copthorne submits that such a conclusion [that Parliament intended to limit the aggregation of paid-up capital (PUC) on a vertical amalgamation] could only rest upon a *general* policy against surplus stripping. It argues that no such general policy exists and therefore the object, spirit and purpose of s. 87(3) cannot be to prevent surplus stripping by the aggregation of PUC. This argument is based upon this Court's admonition in *Trustco* that "courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions

89 *McMullen*, supra note 58.

90 *Ibid.*, at paragraph 54.

91 *Ibid.*, at paragraph 56.

92 *Desmarais v. The Queen*, 2006 TCC 44.

93 *Ibid.*, at paragraph 28.

in issue” (para. 41). What is not permissible is basing a finding of abuse on some broad statement of policy, such as anti-surplus stripping, which is not attached to the provisions at issue. However, the tax purpose identified in these reasons is based upon an examination of the PUC sections of the Act, not a broadly stated policy. The approach addresses the rationale of the PUC scheme specifically in relation to amalgamation and redemption and not a general policy unrelated to the scheme under consideration.⁹⁴

In *Coptborne*, Rothstein J focused on the purpose of subsection 87(3), noting that while continuity of the PUC of the shares of an amalgamated corporation in a horizontal amalgamation is one of the purposes of subsection 87(3), the parenthetical portion dealing with vertical amalgamations, which functions to cancel the PUC of the shares, reflects an additional purpose. Accordingly, the transactions were found to be abusive on the basis of the rationale of the PUC scheme specifically in relation to amalgamations and redemptions, and not on the basis of an unrelated general scheme.

Rothstein J further confirmed that there is no general policy against corporate reorganizations:

Coptborne also argues that the Act does not contain a policy that parent and subsidiary corporations must always remain as parent and subsidiary. I agree. There is no general principle against corporate reorganization. Where corporate reorganization takes place, the GAAR does not apply unless there is an avoidance transaction that is found to constitute an abuse. Even where corporate reorganization takes place for a tax reason, the GAAR may still not apply. It is only when a reorganization is primarily for a tax purpose and is done in a manner found to circumvent a provision of the *Income Tax Act* that it may be found to abuse that provision. And it is only where there is a finding of abuse that the corporate reorganization may be caught by the GAAR.⁹⁵

In *MacDonald*,⁹⁶ also a surplus-stripping case, the Federal Court of Appeal overturned the Tax Court’s decision and held that subsection 84(2) applied on a technical basis; it declined to deal with the GAAR issue on the ground that it was unnecessary to do so. The GAAR issue was addressed by the Tax Court, which noted that the GAAR analysis would be complete only if it addressed the minister’s concerns about surplus stripping per se. However, the Tax Court concluded that it is doubtful

94 *Coptborne*, supra note 12, at paragraph 118. In *Gwartz*, supra note 81, at paragraphs 50-51, the Tax Court confirmed that surplus stripping does not inherently constitute abusive tax avoidance. However, in CRA document no. 2012-0433261E5, June 18, 2013, the CRA stated that notwithstanding *Gwartz*, the CRA intends to demonstrate to the court, “at the next opportunity,” that there is an overall scheme of the Act against surplus stripping. We understand that at the 2013 Canadian Tax Foundation annual conference, the CRA confirmed that it is working on a comprehensive response to surplus stripping (broadly defined), which we understand will delineate between acceptable and unacceptable surplus stripping; however, the CRA acknowledged that it will have to bear in mind the Supreme Court’s conclusions in *Coptborne*.

95 *Coptborne*, supra note 12, at paragraph 121.

96 *MacDonald v. The Queen*, 2012 TCC 123; rev’d. 2013 FCA 110.

whether, in an integrated corporate-shareholder tax system, a surplus strip per se can be said to abuse the spirit and object of the Act read as a whole.⁹⁷

CONCLUSION

As a practical matter, any GAAR issues should be analyzed and the relevant evidence gathered as early in the dispute resolution process as possible. This has the benefit of efficiency but also allows arguments to be tested and revised, and issues to be resolved, early in the process.

One reason why GAAR cases may be difficult to reconcile is that they are unavoidably a highly factual determination. The tax practitioner's role is to ensure that the evidence and facts are properly presented to the CRA officer or the court. Despite clear statements by the courts that GAAR is not a smell test, it will be more difficult in some transactions for the trier of fact to ignore normative considerations and thus raise greater litigation and reputational risks. The jurisprudence indicates that appellate courts will usually defer to the Tax Court of Canada in GAAR cases.⁹⁸

Although taxpayers are rarely successful in rebutting the existence of a tax benefit or an avoidance transaction, they should not concede these points too quickly. We believe that this will be an area of increased dispute resolution activity. Given the onus on taxpayers to rebut the minister's assumptions, it will be important to keep evidence of intention and purpose, which can be used in rebuttal should the minister allege the existence of an avoidance transaction.

Finally, recent trends in GAAR jurisprudence indicate that courts will focus more on the specific policies relied on by the minister. Taxpayers should proactively rebut the minister's position on the policy rationale of specific provisions. This will raise issues, certain to be litigated in the future, of permissible extrinsic evidence, access-to-information requests, and early disclosure of the minister's views as to the policy of provisions of the Act.

97 Ibid. (TCC), at paragraph 101.

98 Li and Hwong, *supra* note 20, at 364. See *Canada Trustco*, *supra* note 3, at paragraph 66: "7. Where the Tax Court judge has proceeded on a proper construction of the provisions of the *Income Tax Act* and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error."