Anniversary Waltz

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October 19th marks the first anniversary of the Supreme Court's landmark GAAR edicts in *Canada Trustco* and *Kaulius*[i]. No, it doesn't seem like yesterday. Since I wrote about these cases last November[ii], a number of important Tax Court of Canada cases have been handed down. In the light of this water under the bridge, I found it interesting to revisit some of my original musings on where the two Supreme Court cases might eventually take us – sometimes when you re-travel a path, you get insight in where it may ultimately lead.

The heart of the *Canada Trustco/Kaulius* cases is the Supreme Court's edict that, in determining whether a transaction is abusive, the lower courts should proceed by conducting a unified textual, contextual and purposive analysis [now referred to by tax drones as "TCP"] of the provisions giving rise to the tax benefit, to determine their object, spirit and purpose.[iii]

Easy to say. But like beauty, would the object, spirit and purpose also be in the eyes of the beholder? I speculated that, while some judges find the task to be truly Herculean, others may find new latitude to conduct a "textual, contextual and purposive" analysis to strike down what they perceive to be odious tax schemes.

So far, this dichotomy – with uncertainty being its inevitable result - seems to be coming to pass. But what is particularly remarkable is the degree of contradiction in the tax court decisions and increasing difficulty of reconciling them.

Analyze This

In *Evans*[iv], a structure involving a dividend strip passed muster with GAAR, but in *Desmarais*[v], the object and spirit of section 84.1 – an anti-strip section - was held to be frustrated.

Both *Desmarais* and *MIL*[vi] involved strategies to nip below a 10% holding – in the former case to escape section 84.1[vii], and in the latter case, to fall within the Canada-Luxemburg tax treaty. The court seemed to have no problem in *MIL*[viii]; however, there was a very different result in *Desmarais.*

While the facts of some of these cases might be a bit exotic, the strategies aren't. *Overs*[ix] and *Lipson*[x]involved essentially the same strategy and provisions, which have been written about on many occasions: taxpayer's spouse borrows money to buy shares of the taxpayer's company from the taxpayer on a rollover basis; because the attribution rules apply (i.e., as a result of interspousal rollover), taxpayer claims the interest expense. In *Overs*, the strategy was used to pay off a shareholder loan balance owing by the taxpayer (from the proceeds of the spouse's bank loan which was used to buy the taxpayer's shares); *Lipson* was a straightforward use of the strategy to make

mortgage interest deductible. The former transaction passed muster with the tax court, while the latter didn't.

The point is that, so far, TCP has caused major uncertainty in respect of tax planning. But while the extent of the inconsistencies is striking, the basic result isn't; in my article nearly a year ago, my concluding words were:

> "I think most practitioners will share my disappointment in the failure of these cases to resolve so much of the uncertainty that has surrounded GAAR. Tax practitioners have had to live with this uncertainty for many years. . . . it looks like this uncertainty will continue in the foreseeable future — and may even worsen in the shorter term."

So where are we going from here? In coming months, a great many GAAR cases will come before our courts, with even more to follow in future years, as I presume that the CRA will be emboldened by its recent victories. But unless taxpayers start to win a lot more cases, I believe that the contradictory nature of GAAR cases will extend to many more situations than in the first year of the post-*Canada Trustco/Kaulius* era, thus Balkanizing tax planning. GAAR is on its way to effectively becoming an act within an act; two loose-leaf services are now devoted exclusively to the topic.

OK – so who's winning – taxpayers or the CRA[xi]? While the tally of taxpayer victories and losses in the post-*Canada Trustco/Kaulius* era is pretty close, I think that, so far, taxpayers have lost more key cases than they have won. Notably, *Lipson* and *Desmarais* are within the realm of many mainline transactions. And my statement last November that transactions which have been taken for granted by practitioners will have to be re-examined bears repeating, a case in point being *Lipson* and mortgage interest deductibility.

But my bottom line on GAAR is no different than it was when it came out nearly twenty years ago – for creative tax planning, it's often a crap shoot. Just how much this is the case is underscored in *Lipson*, in which the Chief Justice of the Tax Court of Canada indicated that each case in which GAAR is applied depends on its own facts, with commercial or estate planning underpinnings being a key factor in deciding on which side of the line a taxpayer ends up.

Besides the TCP analysis in respect of GAAR itself, it was also put forward in *Canada Trustco* as a rule of statutory interpretation. Recent cases show that this approach is now firmly embedded as a rule of statutory interpretation.[xii] Last November, I said that the cases may ultimately allow judges to read more into the Act, but there may also be some good news in that TCP may allow courts to restrict the interpretation of many unduly broad provisions. Although the latter is yet to come to pass, I stick with this prediction.

Eligible Dividend Proposals – Still More Comments

Finally, I would like to make a few further remarks about the eligible dividend proposals in addition to those in my last two articles. They only scratched the surface of technical issues raised by these proposals; I expect many more to emerge in technical papers in upcoming months. To give but one example, proposed subsection 89(7) provides a throw-back rule for taxation years ended after 2000 and before 2006, providing a GRIP addition equal to 63% of a corporation's full rate taxable income. However, this amount is reduced by taxable dividends paid by the corporation in those taxation years. The big problem is where such dividends are paid within a corporate group, e.g., for creditor proofing purposes. There is no provision to enlarge the recipient corporation's GRIP account - the GRIP addition is simply lost. This is but an example of the issues that can be caused by attempting to keep the legislation simple (particularly with comparatively little attempt to deal with corporate groups).

While the proposals encourage the retention of earnings at the corporate level, as opposed to bonusing-down to the small business limit, there are quite a number of considerations in respect of this decision. These include the potential loss of the refundable investment tax credit and in Ontario, the consequences of the "claw-back" – a 4.67% tax increase between income levels of $400,000 and above $1.1M. On the other hand, if the corporation subsequently incurs tax losses, carrybacks should be more tax effective, since corporate losses cannot shelter income bonused out to the owner manager.

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[i] *Canada Trustco Mortgage Co.* v. *Canada*, 2005 DTC 5523; *Mathew* v. *Canada*, 2005 DTC 5538.

[ii] "Magical Mystery Tour – The Supreme Court's GAAR Cases", *Tax Notes* #514, November 2005.

[iii] Thus, there is to be a two-step process:

- Step 1: Determine the object, spirit or purpose of the provision in question through textual, contextual, and purposive analysis.

- Step 2: Examine the factual context to determine whether the avoidance transaction defeated or frustrated the object, spirit, or purpose of the provisions.

"Textual" means that you look at the actual words of the tax provisions in issue; "contextual" means that you consider the provisions within the context of the other tax provisions in the Act; "purposive" means that you interpret the words in accordance with the purpose of the provision in question, presumably determined having regard to the scheme of the Act, the relevant provisions, and permissible extrinsic aids.

[iv] 2005 DTC 1762.

[v] 2006 TCC 144.

[vi] *MIL (Investments) S.A.* v. *The Queen,* Docket 2004-3354(IT)G.

[vii] This depends on "connected" status – in this case, more than 10% of votes and value.

[viii] The court found that this and other transactions preceding the sale of shares covered by the Canada-Luxembourg treaty were not avoidance transactions and were not part of the same series of transactions as the sale.

[ix] 2006 TCC 26.

[x] Docket. 2002-1862(IT)G.

[xi] In my article last year, I indicated that *Canada Trustco* and *Kaulius* move the bar in favour of the CRA vis-à-vis the pre-existing law.

[xii] See *Grant,* v. *The Queen*, 2006 TCC 373; *The Queen* v. *Stapley*, 2006 FCA 36; *Humphrey* v. *The Queen*, 2006 TCC 168; *GKN Sinter Metals - St. Thomas Ltd.* v. *The Queen*, 2006 DTC 325 (TCC); *Fenner* v. *The Queen*, 2006 TCC 396.