Magical Mystery Tour – The Supreme Court's GAAR Cases

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*(*This release is based on an article published Tax Topics, November 10, 2005, No.1757 , CCH Canadian Limited)*

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I have been asked to comment on the longer-term impact of the Supreme Court's pair of GAAR decisions, *Canada Trustco* and *Kaulius* [1]- the most important Canadian tax cases in a generation (for a detailed analysis of the cases themselves, see Joe Frankovic's article in last week's *Tax Topics*).

The cases raise some fundamental issues, including the following:

- Do they give the lower court more latitude to conclude there is an abusive transaction?
- Are the chances of a successful appeal of a Tax Court of Canada GAAR decision now restricted?
- What is the significance of a non-tax purpose in the context of GAAR?
- While the Minister now clearly has the onus of showing there is abuse, how high is this onus?
- Will the cases generally affect statutory interpretation – i.e., apart from GAAR itself?

Many of my comments are largely speculative; it may be years before some of the issues are sorted out. I think that *Canada Trustco* in particular is one of those cases containing many concepts and statements the significance and nuances of which will be revealed only as case law and analysis evolve. (For example, while at a glance, the Court seems to accept the famous *Duke of Westminster* case, a close reading reveals that it may be "attenuated" by GAAR[2].) At times, I felt that I had a better shot at figuring out the backward lyrics in the Abbey Road album than some of the nuances of the case.

Long and Winding Road

The split decision (i.e., the win in *Canada Trustco* and loss in *Kaulius*) did not come as a surprise to tax advisors. However, my personal feeling is that this outcome should not be taken to be a "draw" between taxpayers and the CRA; overall, I regard the cases as a set-back for taxpayers, if for no other reason than because of the uncertainty as to the application of GAAR - that may worsen in their wake.[3]

The heart of the cases is the Supreme Court's edict that, in determining whether a tax transaction is abusive[4], the lower courts should proceed:

... "by conducting a unified *textual, contextual and purposive* analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the context of the whole Act. . . . The central issue is the proper interpretation of the relevant provisions in light of their context and purpose. Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer

the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions".[5]

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[6]

[Note: for those who are afraid to ask, "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.]

GAAR may be applied to deny a tax benefit only after it is determined that it was not reasonable to consider the tax benefit to be within the object, spirit or purpose[7] of the provisions relied upon by the taxpayer.[8] Much of the foregoing is repeated, Mantra-like, throughout the cases.[9]

Hard Day's Night – New Tasks for the Tax Court

The *OSFC* Federal Court of Appeal decision[10] required offending a clear and unambiguous policy before GAAR applied. While it is debatable whether the wording of *Canada Trustco* is a marked departure from this test [11], it is the *example* in *Kaulius* that the Supreme Court sets in divining "purpose" that troubles me. While some of the statements about the "purpose" of the stop-loss rules in subsection 18(13) - on which the Kaulius structure depended – are fair enough, others seem to be put forward without apparent analysis of the Court's rationale[12]. What kind of example does this provide for lower courts? Like beauty, will "purpose" also be in the eyes of the beholder? Will some judges find the task of divining "purpose" to be truly Herculean[13], while others find new latitude - in their directive to conduct a "textual, contextual and purposive" analysis - to strike down what they perceive to be odious tax schemes?

Latitude to divine "purpose" may become particularly important because the cases also decree that a Tax Court finding cannot be lightly overturned. As the Supreme Court states:

"Provided the Tax Court judge has proceeded on a proper construction of the provisions of the Act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error".[14]

It remains to be seen as to how appellate courts will react to this statement, and in particular, the extent to which it will be perceived as restricting the ability to reverse determinations of law, notably the "purpose" of provisions in question. Obviously, though, the statement (along with the Court's decree that an abuse inquiry is one of mixed fact and law[15]) provides a convenient excuse for appeals judges to wash their hands of these difficult cases.

Get Back

Also “interesting” in *Canada Trustco* is the Court’s willingness to embrace the original Explanatory Notes to GAAR (in fact, the case seems pretty consistent with the Notes cited in *Canada Trustco.)*[16] In particular, both the Notes and the Court place emphasis on the significance of a “non-tax purpose” - not only in the determination of whether there is an avoidance transaction (per subsection 245(3)), but also in the context of whether the transaction is abusive pursuant to subsection 245(4) (as part of the analysis of a particular provision – i.e., which when “properly interpreted” may “dictate” a consideration of such purpose)[17]. True, the Court states that the absence of a non-tax purpose is not in itself sufficient to establish abusive tax avoidance.[18] But at another point in the case the Court also emphasizes that “the Explanatory Notes also elaborate that the provisions of the *Income Tax Act* are intended to apply to transactions with real economic substance”,;[19] to my mind, this elevates non-tax purpose to a high-enough level to be emphasized in future cases. A generation ago, the *Stubart* case[20] indicated that it was not necessary for transactions to have “business purpose” to succeed. However, these cases entrench non-tax purpose/economic substance as an element in GAAR survivability.

We Can Work it Out

The cases may ultimately allow judges to read more into the Act. In a search for a “contextual” and “purposive” approach to interpretation, courts are directed that: “Even where the meaning of particular provisions may not appear to be ambiguous at first glance, statutory context or purpose may reveal or resolve latent ambiguities."[21] Sound like an invitation? Earlier in *Canada Trustco*, the Court states that “when the words of a provision are precise and unequivocal, the ordinary meaning of the words play a ***dominant*** [*i.e., not “conclusive”*] role in the interpretive process."[22] If you ask me, there may actually be good news here: this may allow courts to restrict the interpretation of the many overly-broadly-drafted provisions that seem to permeate the *Income Tax Act* nowadays. Particularly if such provisions are litigated, the cases could lead to decisions that put more emphasis on interpretations that depart from the textual approach which has previously been so important.[23]

The cases put the onus of showing there is abusive tax avoidance squarely on the CRA, and state that the abuse must be clear, with the result that doubts must be resolved in favour of the taxpayer. This has led to optimism on the part of many practitioners. Personally, I have more of a question in my mind as to how much movement there has been from *OSFC* – practically speaking, that is[24]. We will have to wait to see how *high* this onus is and generally, how this will play out.

On the whole, I think that the two cases move the bar in favour of the CRA, as compared to how things might have unfolded in a steady-state *OSFC* universe. Transactions that have been taken for granted by practitioners will have to be re-examined, particularly those that are purely tax-motivated; a non-tax purpose will become more important if a transaction is to survive GAAR. If my concerns about disparities in future Tax Court of Canada decisions prove to be well founded, GAAR reassessments may become more common than might have otherwise been the case.

While this may be debatable, 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 nearly a generation. In the absence of future tax changes (if any) that may result from these cases, it looks like this uncertainty will continue in the foreseeable future - and may even worsen in the shorter term. On a happier note, because there are presumably a large number of GAAR cases working their way towards the courts, some of the key issues courts should be on their way to a resolution within months rather than years.

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[1] *Canada Trustco Mortgage Co.* v. *Canada,* 2005 SCC 54; *Mathew v. Canada,* 2005 SCC 55.

[2] *Canada Trustco*, paragraph 13.

[3] Reactions from leading firms ranged from optimism as to taxpayers' future successes, to a sense of foreboding about the latitude that the Tax Court now has. Interestingly, the accounting firms' releases tended to be more optimistic than those of the law firms.

[4] Of course, the abuse issue is the third step – the most problematic – in determining the application of GAAR: it must first be determined whether there is a "tax benefit"; then, whether transaction is an "avoidance transaction" – i.e., a transaction that results in a tax benefit either by itself or as part of a *series of transactions*, 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. The issues pertaining to these requirements are not discussed in this article.

[5] *Canada Trustco* paragraph 66; *Kaulius*, paragraph 31.

[6] Of course, the cases also indicate that the analysis of misuse of the provisions of the Act and abuse having regard to the provisions of the Act read as a whole are inseparable.

[7] Hereinafter, "purpose".

[8] *Canada Trustco*, paragraph 62.

[9] Paragraph 45 of *Canada Trustco* received comparatively little attention in the early law and accounting firm releases on these cases. However, it provides some relatively explicit observations on when a finding of abusive tax avoidance might apply, namely:

- when a taxpayer relies on specific provisions of the *Income Tax Act* in order to achieve an outcome that those provisions seek to prevent;
- when a transaction defeats the underlying rationale of the provisions that are relied upon;

– from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions.

[10] *OSFC* v. *The Queen,* 2001 DTC 5471, FCA.

[11] Compare paragraphs 70 of *OSFC* and 62 of *Canada Trustco.* The former speaks to a clear and unambiguous "policy" (as defined in paragraph 66) and suggests a cautious approach. The latter indicates that the abusive nature of the transaction must be clear [does this inherently require that the "purpose" also be clear?], but suggests a test of reasonability; e.g., that a transaction will be abusive where it cannot be reasonably entertained that the avoidance transaction was consistent with the object, spirit or purpose of the provisions of the Act. (The reasoning in this paragraph is stated to be based on the double negative in subsection 245(4), which is no longer present. However, the Supreme Court indicated (*Canada Trustco,* paragraph 7) that the amendments to the provision "would not warrant a different approach to the issues on appeal".)

[12] Paragraph 52 states that:

> "The purpose for the broad treatment of loss sharing between partners is to promote an organizational structure that allows partners to carry on a business in common, in a non-arm's length relationship."

The Court gives no clue as to how it comes to this conclusion or, for that matter, why a partnership is inherently a non-arm's length relationship. I understand that neither party raised this proposition in either their factums or oral argument.

[13] With so little direction in the cases themselves, how will the lower courts accomplish this task? In the '70s, the meaning of "active business" was not specifically defined in the Act and therefore left to the courts to determine. In my view, the end result was that the courts effectively abdicated in favour of taxpayers, with the end result being that it took very little activity to constitute an active business. (See, for example, *The Queen v. M.R.T. Investments Ltd.*, 76 DTC 6158 (F.C.A.); *E.S.G. Holdings Ltd. v. The Queen*, 76 DTC 6158 (F.C.A.).) In the same vein, is it possible that one approach could be to effectively abdicate the task of the analysis mandated by these cases, perhaps on the ground that the Crown did not meet its onus of showing abuse?

[14] *Canada Trustco*, paragraph 46.

[15] *Canada Trustco*, paragraph 44.

[16] See paragraph 65 of *Canada Trustco* in particular.

[17] See *Canada Trustco*, paragraphs 59; 66, #5.

[18] See paragraphs 57 and 58 of *Canada Trustco*. A non-tax purpose includes an economic, commercial, or family purpose.

[19] *Canada Trustco*, paragraph 49.

[20] 84 DTC 6305, SCC.

[21] *Canada Trustco*, paragraph 47. The reasoning of the Supreme Court here is reminiscent of their decision in *The Queen v. Province of Alberta Treasury Branches*, 96 DTC 6245.

[22] *Canada Trustco*, paragraph 10. Contrast this to the Supreme Court's previous decisions in *Antosko v. The Queen*, 94 DTC 6314 and *Friesen v. The Queen*, 95 DTC 5551.

[23] The link between GAAR and statutory interpretation, and in particular, the concept that subsection 245(4) should be determined by applying to the provisions in issue the rules of statutory interpretation generally applicable to tax statutes has previously been put forward. I find an article by John R. Owen ("Statutory Interpretation and The General Anti-Avoidance Rule: A Practitioners Perspective", 98 *CTJ* 2, p.233) to be particularly interesting. The author puts forward an approach to determining whether there is an abuse under which:

. . .the court is not confined to a literal interpretation of the provision in assessing whether it has been misused or abused, but rather is entitled to consider the purpose of the provision as reasonably construed from its language and the context in which it is found. This approach does not, however, provide the courts with *carte blanche* to attribute to Parliament an intention (or lack thereof) that cannot reasonably be extracted from the language of the provision or the context in which it is placed.

Prophetic words indeed.

[24] As noted in paragraph 64 of *Canada Trustco*, *OSFC* stated that, "from a practical perspective, . . . [t]he Minister should set out the policy with reference to the provisions of the Act or extrinsic aids upon which he relies". The Supreme Court saw no reason to maintain any distinction between a practical and theoretical perspective on the burden of proof.