blue J LEGAL TAX FORESIGHT

General Anti-Avoidance Rule
Pursuant to section 245 of the *Income Tax Act*

Tax Foresight Primer Series

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The general anti-avoidance rule ("GAAR") in section 245 of the Income Tax Act ("ITA") attempts to strike a balance between legitimate tax mitigation and abusive tax avoidance (or "lawful" and "unlawful" avoidance). While the line is not clear, insights can be gained from the roughly 100 rulings handed down since the GAAR's enactment. Tax Foresight's GAAR Case Finder allows the user to search the entire body of GAAR case law by facts and outcomes, and filter by factors with varying weights. This primer explains the legal framework for GAAR cases and provides examples of insights that can be gained using the Case Finder.

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Introduction

Canadian tax law recognizes the taxpayer's entitlement to arrange his or her affairs so as to attract the least amount of tax. This principle derives from *Inland Revenue Commissioners v. Duke of Westminster*, (1935) 19 TC 490 (UK HL), in which Lord Tomlin stated:

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

The scope of this entitlement is limited by statutory restrictions on tax avoidance. Specific anti-avoidance provisions can be found in Part XVI of the *Income Tax Act* ("ITA") and throughout tax legislation generally. In 1988, Parliament enacted the general anti-avoidance rule ("GAAR") as a supplementary rule of last resort. The purpose of the GAAR is to address abusive tax avoidance while preserving consistency, predictability, and fairness in tax law.[1] It will be applied to deny a tax benefit only when the abusive nature of the transaction is clear.[2] The charging provision is found in subsection 245(2) of the ITA:

> 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 includes that transaction.

The terms "tax benefit," "tax consequences," and "transaction" are defined in subsection 245(1) and "avoidance transaction" is defined in subsection 245(3). The "abuse" requirement derives from subsection 245(4).

Overview of the Legal Test

A three-step test for the application of GAAR was set out in *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 ("*Canada Trustco*") and clarified in *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 ("*Copthorne Holdings*"):

1. Is there a tax benefit?;
2. Is the transaction giving rise to the tax benefit an avoidance transaction?; and
3. Is the avoidance transaction giving rise to the tax benefit abusive?

Steps 1 and 2 are not often contentious. Step 3 tends to be the focus of the court's analysis. Each step is reviewed in detail below, accompanied by insights from the GAAR Case Finder.

Tax Benefit

Tax Benefit Determination

The first step is to determine whether there is a "tax benefit" arising from a transaction or series of transactions within the meaning of subsections 245(1) and (2). This is a question of fact and the burden of proof is on the taxpayer. A tax benefit was found (or conceded by the taxpayer) in 97% of rulings.

Type of Benefit

A tax benefit is generally defined as a reduction, avoidance or deferral of tax, or an increase in a refund. A reduction or avoidance of tax is the most common form of benefit found in GAAR cases, present in 93% of rulings in which there was a tax benefit. A deferral of tax is uncommon, present in 10% of rulings in which there was a tax benefit. An increase in a refund is extremely rare, present in only 3% of rulings in which there was a tax benefit.[3]

[1] *Canada Trustco v. Canada*, 2005 SCC 54, at paragraph 61 ("*Canada Trustco*").

[2] *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 ("*Copthorne*"), at paragraph 68, citing *Canada Trustco*, *ibid.*, at paragraph 50.

[3] The increase in refund cases are *Excise Tax Act* GAAR cases, which apply the same legal test.

Level of Analysis

In most cases, it is obvious whether there is a tax benefit. In fact, this issue has been conceded in over 60% of rulings. In 32% of rulings, while the issue was not conceded, the court found that there was clearly a tax benefit. For example, if a taxpayer has claimed a deduction against taxable income, it is usually clear that a tax benefit exists, since a deduction results in a reduction of tax. The existence of a tax benefit may also be established by comparison with an alternative arrangement.[4] In *Copthorne Holdings*, the tax-free redemption of shares after a vertical amalgamation was found to provide a tax benefit when compared to the withholding tax that would have resulted from the redemption of shares after a horizontal amalgamation.

In the remaining 8% of rulings, the court has engaged in a lengthy discussion of whether there was a tax benefit. For example, in *594710 British Columbia Ltd. v. The Queen*, 2016 TCC 288, the taxpayer and the Minister put forward different comparators for the court's assessment of whether there was a tax benefit. The court found that the taxpayer failed to demonstrate the reasonableness of its proposed comparator, and there was a tax benefit. The determination was also more complex than other cases in that the tax benefit did not accrue in the tax year under appeal or to the person to whom the tax consequences were re-determined by application of the GAAR.

Avoidance Transaction

Avoidance Determination

The second step is to determine whether the transaction is an "avoidance transaction" within the meaning of subsection 245(3). A transaction is an avoidance transaction if it or the series of which it is a part results in a tax benefit and is not undertaken for a *bona fide* non-tax purpose. This is a question of fact and the burden of proof is on the taxpayer. Avoidance has been found in over 80% of rulings.

Series of Transactions

Many GAAR cases involve complex business arrangements, and the question is whether the "series of transactions" resulted in a tax benefit. Approximately 13% of decisions include a detailed analysis of the definition of "series." The common law principle from English law is that a series comprises a set of transactions pre-ordained to produce a final result.[5] This definition is expanded by subsection 248(10) of the ITA (enacted before the GAAR), which provides that a series shall be deemed to include any related transactions or events completed "in contemplation of" the series.[6] In assessing whether a related transaction was completed "in contemplation of" a series, a court is required to consider whether the series was taken into account when the decision was made to undertake the related transaction, in the sense that it was done "in relation to" or "because of" the series.[7]

The Supreme Court of Canada provided some clarity in *Copthorne Holdings*, confirming that (A) connecting a transaction with a series does not require a "strong nexus," but does require more than a "mere possibility" or an "extreme degree of remoteness,"[8] and (B) either a prospective or retrospective connection is sufficient.[9] Therefore, even if an avoidance transaction takes place after a transaction that did not contemplate avoidance at that time, the two can still form a series caught by the GAAR. In *Copthorne Holdings*, for example, a series involving a horizontal amalgamation that preserved paid-up capital ("PUC") was sufficiently connected to a share redemption more than a year later. The redemption was exactly the type of transaction necessary to realize a tax benefit based on the preservation of PUC.

Post-*Copthorne Holdings*, there are no rulings with a negative finding on the question of whether a particular transaction was part of a series that resulted in a tax benefit.

[4] *Canada Trustco, supra* [1], at paragraphs 19-20.
[5] *OSFC Holdings Ltd. v. The Queen*, 2001 FCA 260 ("*OSFC Holdings*"), at paragraph 24.
[6] Discussed in *OSFC Holdings*, at paragraph 36.
[7] *Canada Trustco, supra* [1], at paragraph 26.
[8] *Copthorne Holdings, supra* [2], at paragraph 47.
[9] *Ibid.*, at paragraph 56.

Bona Fide Non-Tax Purpose

The purpose of the transaction is the fundamental inquiry in determining whether it is an "avoidance transaction." The analysis is objective and is determined by a court's examination of the relevant facts and circumstances; the taxpayer's assertions of his or her motives are not determinative.[10] In order for a transaction not to be considered an "avoidance transaction," it must be supported by a reason other than the tax benefit it conferred, and such non-tax purpose must be primary.[11] In the majority of rulings (over 56%), courts have found no *bona fide* non-tax purpose. A non-primary *bona fide* non-tax purpose has been identified in 24% of rulings. A primary *bona fide* non-tax purpose has been found in 20% of rulings, which are precisely the rulings with a negative avoidance determination.

It is critical to note that this is not simply a business purpose test (although business is the most common *bona fide* non-tax purpose identified by the courts, in over 80% of rulings where a non-tax purpose was found and 35% of rulings overall). The ITA refers to "*bona fide* purposes other than to obtain a tax benefit" rather than the originally proposed "*bona fide* business purposes" because non-business reasons can justify the structure of arrangements.[12] Such non-business reasons include protection from creditors, family and estate arrangements, philanthropy, and foreign tax planning. Creditor protection is the only non-business reason that has led to a negative avoidance determination to date.[13]

Misuse or Abuse

Misuse or Abuse Determination

The third step is to determine whether the avoidance transaction constitutes misuse or abuse under subsection 245(4). This is the focus of any GAAR analysis. It is important to note that the "misuse" and "abuse" determinations are not separate inquiries.[14] There is abusive tax avoidance if it cannot reasonably be concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer. This is a mixed question of fact and law, and the burden of proof is on the Minister. If the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer. Overall, misuse or abuse has been found in approximately 44% of rulings, and the GAAR was found to be applicable in approximately 42%.[15]

How Misuse or Abuse was Alleged and Found

The Minister may allege misuse or abuse of specific provisions of the ITA or the regulations, a tax treaty, or abuse of the ITA as a whole. Prior to *Canada Trustco*, allegations of abuse of the ITA as a whole were more common. Courts tended to examine the legislation and identify broad tax policies that may have been offended. The analytical framework established by *Canada Trustco* calls for a textual, contextual, and purposive interpretation of the provisions that were relied upon by the taxpayer in obtaining the tax benefit, to determine why they were put in place and why the benefit was conferred. Courts examine the factual context to determine whether the avoidance transaction defeated or frustrated the object, spirit, or purpose of the provisions in question.[16] Tax Foresight's Case Finder also identifies cases that include allegations of abuse of the *Excise Tax Act* or provincial tax legislation.

Provisions Alleged to be Misused or Abused

Among the decided cases, the Minister has alleged misuse or abuse of over 60 different sections of the ITA (and over 80 individual subsections, paragraphs, and subparagraphs) and courts have found misuse or abuse of over 40 different sections (and over 60 individual subsections, paragraphs, and subparagraphs). In addition, over 20 specific anti-avoidance provisions have been considered.

[10] *OSFC Holdings, supra*[5], at paragraph 46.
[11] *Canada Trustco, supra*[1], at paragraph 27.
[12] *Ibid.*, at paragraph 33.
[13] See *1207192 Ontario Ltd. v. The Queen*, 2012 FCA 259 and *McClarty Family Trust v. The Queen*, 2012 TCC 80.
[14] *Canada Trustco, supra*[1], at paragraph 39; *Copthorne Holdings, supra*[2], at paragraph 73.
[15] The discrepancy between these two percentages derives from cases in which the court only addressed the application of GAAR in *obiter*.
[16] *Canada Trustco, supra*[1], at paragraph 55.

Transaction Types and Common Allegations of Misuse or Abuse

The GAAR Case Finder classifies cases by the types of arrangement to which the GAAR is being applied. This section describes some of the relevant categories and insights provided by the Case Finder.

Loss Transfers or Synthetic Losses

The GAAR was found to be applicable to transactions that involve loss trading between unrelated parties and the creation of artificial losses. Such transactions have been found to defeat the rationale underlying ITA provisions that allow for the legitimate deduction of business losses. Provisions of the ITA commonly considered within this category of cases include sections 3, 4, 9, 38, 39, 40, and 111. The GAAR was found to be applicable in over 60% of rulings in this category. For example, in *Global Equity Fund Ltd. v. The Queen*, 2012 FCA 272, the GAAR was applied to a series of transactions used to transfer value from common shares to preferred shares, with the result that the common shares were left with little value and a high cost, while the preferred shares had a high value and a low cost. When the common shares were sold, the taxpayer realized a large loss for tax purposes but was not actually any poorer after the transactions. In *Birchcliff Energy v. The Queen*, 2015 TCC 232, the GAAR was applied to a series of transactions in which an amalgamation was orchestrated so as to avoid change of control restrictions and the loss streaming rules, thus facilitating the deduction of non-capital losses.

Partnership Utilization

Partnerships are commonly used in tax planning due to their flow-through nature[17] and GAAR issues may arise in cases involving partnership structures. Provisions of the ITA commonly considered within this category of cases include sections 18, 96, and 97. The GAAR was found to be applicable in 50% of decisions in this category. For example, in *CECO Operations Ltd. v. The Queen*, 2006 TCC 256, the GAAR was applied to a transaction involving the use of the elective partnership rollover provision in subsection 97(2) to indefinitely defer taxation on the proceeds of the sale of a business. Although the transaction technically met the requirements for the rollover, there was in essence non-partnership interest consideration greater than the cost of the transferred property (the maximum permitted), in the form of an investment by the partnership in another entity related to the partner. This was abusive of subsection 97(2).

Paid-Up Capital Shifting or Creation

Shares bearing higher PUC (which is generally the amount originally paid for the shares when they were issued by the corporation) have the potential to reduce tax liability in many circumstances, particularly for non-resident shareholders. This possibility frequently leads taxpayers to take measures to preserve or increase the PUC of particular shares or classes of shares. The GAAR has been applied when an artificial increase in PUC causes a corresponding artificial reduction in tax liability. Provisions of the ITA commonly considered within this category of cases include sections 84, 87, and 89. The GAAR was found to be applicable in 70% of decisions in this category. For example, the GAAR was applied in *Copthorne Holdings*, where the taxpayer performed a series of transactions to facilitate a horizontal amalgamation rather than a vertical amalgamation, and a subsequent share redemption was thereby made tax-free. Through the operation of subsection 87(3) of the ITA, the PUC of the amalgamating corporations was preserved, whereas if the amalgamation had been carried out vertically, the PUC of the subsidiary would have been cancelled. The court found that the transaction was abusive of subsection 87(3) because it effectively allowed for the tax-free withdrawal of amounts in excess of the investment made in the corporation. The taxpayer "artificially" preserved the PUC in a way that frustrated the purpose of subsection 87(3) governing the treatment of PUC upon vertical amalgamation and thus achieved a result that the provision was intended to prevent.

[17] A partnership is generally not taxed as a separate entity (except for SIFT partnerships). Rather, each partner must include in income that partner's share of the income of the partnership for the fiscal period ending in the taxation year of the partner. Subsection 96(1) of the ITA requires the determination of income at the partnership level which must be computed as though the partnership were a separate person.

Surplus Stripping

Surplus stripping occurs when a shareholder effectively extracts profits earned in a corporation (generally through a transaction characterized as a sale of shares giving rise to a capital gain), without any distribution from the corporation taxed as a dividend. The analysis of such cases has become more restrictive post-*Canada Trustco*, as the analytical framework now requires a comprehensive analysis of the purpose of the transaction and the relevant provisions. Sections of the ITA commonly considered within this category of cases include 84, 84.1, and 212.1. The GAAR was found to be applicable in over 55% of decisions in this category. For example, in *Descarries v. The Queen*, 2014 CarswellNat 584, the GAAR was applied to a series of non-arm's length transactions that effected the distribution of a corporation's surplus in the form of a capital gain. In contrast, the GAAR was not applied in *Evans v. The Queen*, 2005 TCC 684 and *McMullen v. The Queen*, 2007 TCC 16. In both cases, the court found that the transactions may reasonably be considered to have been arranged primarily for *bona fide* business purposes.

Spousal Attribution Rules

The goal of the spousal attribution rules in sections 73 and 74.1 of the ITA is to prevent income splitting. If they are used to confer a tax benefit instead, this goal is frustrated and the GAAR may be applied to deny the benefit. For example, in *Lispon v. Canada*, 2009 SCC 1, the attribution rules were used to enable Mr. Lipson to claim Mrs. Lipson's deduction for personal residence mortgage interest. The GAAR was applied because the attribution rules were not intended to be used in this manner to reduce tax liabilities, even though the rule technically applied according to its literal terms.

Debt Forgiveness Rules

When a taxpayer is relieved of the obligation to pay certain debts, section 80 of the ITA generally requires the taxpayer to reduce either the losses created by the expenses funded by the debt, or the cost of the property acquired with the debt, since the taxpayer will not have suffered the loss or borne the cost of the capital expenditure. In *Pieces Automobiles Lecavalier Inc. v. The Queen*, 2013 TCC 310, the GAAR was applied to a series of transactions that sought to clean-out the debt of an "underwater" taxpayer and allow the taxpayer to retain losses that would have been otherwise reduced by section 80 following the sale of the shares and debt of the taxpayer by its foreign parent company.

Treaty Issues

The GAAR has been raised but inconsistently applied in cases involving the interaction between tax treaties and the ITA. It is interesting to note that many of the cases in this category have been appealed and upheld on grounds other than GAAR. For example, in *Antle v. The Queen*, 2009 TCC 465, a Barbados spousal trust was established to effectively step-up the tax basis in property and "return it to the Canadian marital unit" for the purpose of escaping the payment of Canadian tax. The Tax Court of Canada determined that this was an abuse of the ITA, the Canada-Barbados tax treaty, and their joint operation. The result was upheld in 2010 FCA 280 on the basis that the trust was a sham.

Kiddie Tax

The GAAR may be applied to transactions involving the avoidance of the "kiddie tax" imposed by s. 120.4 of the ITA (equal to the highest individual tax rate for the year multiplied by certain passive income of individuals under 18). In *McClarty Family Trust v. The Queen*, 2012 TCC 80, the GAAR was raised but not applied to a series of transactions involving the payment of a stock dividend and the triggering of a capital gain in the hands of a minor. The court found that the transactions had a primary creditor protection purpose. In *Gwartz v. The Queen*, 2013 TCC 86, the GAAR was not applied to a series of transactions involving the payment of stock dividends to a family trust in order to create capital gains and avoid the kiddie tax.

Interest Expense Deductions

Interest expense deductions are frequently challenged under the GAAR. The GAAR was found to be applicable in over 30% of decisions in this category. For example, in *722540 Ontario Inc. v. The Queen*, 2001 CarswellNat 3015 (TCC), the GAAR was applied to a series of transactions in which money was borrowed and invested in a company that had losses and no ongoing business. The taxpayer did not use the borrowed money for the purpose of earning income as required by paragraph 20(1)(c). Rather, the loan was used solely to create the tax losses. The transaction frustrated the purpose of paragraph 20(1)(c), which is to incentivize the accumulation of capital with income-producing potential by allowing the deduction of interest associated with the acquisition of that capital. The taxpayer created a net interest deduction that reduced its income, the opposite of the provision's purpose.

Donations to Charitable Organizations

The GAAR has been raised but not applied in cases involving donations to charitable foundations controlled by the taxpayer, such as *Remai Estate v. The Queen*, 2009 FCA 340 and *Jabs Construction Ltd. v. The Queen*, 1999 CarswellNat 1210 (TCC).

Withholding Taxes

This category of cases commonly involves section Part XIII of the ITA and the scope of withholding tax exemptions. Section 212.1 is meant to ensure that in non-arm's length transactions, tax free distributions from Canadian corporations to non-resident shareholders are limited to PUC. Recently, the Federal Court of Appeal released its decision in *Univar Holdco Canada ULC v. The Queen*, 2017 FCA 207, overturning the judgment of the Tax Court of Canada and finding that the GAAR did not apply to a series of transactions structured to utilize an exemption in subsection 212.1(4) (which was subsequently amended) to facilitate the extraction of Canadian surplus without payment of withholding tax.

CCA

The GAAR has been raised (in most cases, unsuccessfully) to challenge a taxpayer's capital cost allowance deductions. The most notable case in this category is *Canada Trustco*. The Supreme Court of Canada rejected the Minister's argument that the transactions manufactured a cost for CCA purposes that did not represent the real economic cost of the assets sold and leased. In holding that "cost" means cost understood at law, namely the amount paid, the court concluded that the deductions taken by the taxpayer were consistent with the spirit and purpose of the CCA provisions of the ITA and regulations.

Non-federal Income Tax

As mentioned above, the *Excise Tax Act* and provincial tax statutes also contain general anti-avoidance rules for which courts apply the same legal test. Tax Foresight's Case Finder includes these cases within the "Non-federal income tax" category.