Supreme Court of Canada Renders Decisions on the General Anti-Avoidance Rule

On October 19th, the Supreme Court of Canada ("SCC") released its decisions in two important tax cases, *Canada Trustco Mortgage Co. v. The Queen* (a sale-leaseback arrangement) and *Mathew et al. v. The Queen* (a partnership structured to access tax losses). These decisions were much anticipated by Canada's tax community as they represent our highest court's first opportunity to interpret and provide guidance on the application of the general anti-avoidance rule ("GAAR"). This is a provision which has created a fair amount of uncertainty for Canadian tax planners in structuring their clients' affairs due to the potentially broad power that it gives to the Canada Revenue Agency ("CRA") to recharacterize transactions in order to deny tax benefits.

The SCC's two unanimous decisions put to rest much of this uncertainty as they provide tax advisors and Canada's courts with the analytical test to be followed when considering the possible application of the GAAR to a specific set of facts. Perhaps most importantly, the SCC has firmly placed the burden of proof on the CRA to establish that there was abusive tax avoidance. Also, it was held that the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is "clear". This appears to set a high standard for the CRA to satisfy.

However, as the SCC recognized, the line between legitimate tax minimization and abusive tax avoidance "is far from bright". As a result, there is no doubt that the CRA will continue to challenge transactions by invoking the GAAR. These two cases demonstrate this fine line.

The Origin of the GAAR

The GAAR was enacted in 1988, principally in response to another decision of the SCC (*Stubart Investments Ltd.)* which rejected the business purpose test, which would have restricted tax reduction to transactions with a real business purpose. Parliament considered the *Stubart* decision to be an inadequate response to the perceived problem and enacted the GAAR. According to the drafters of the GAAR, it was intended "to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs." In practice, however, the general language used in the GAAR provisions created uncertainty in assessing the possible scope of the rule.

The Supreme Court's Approach to the GAAR

The approach to the GAAR adopted by the SCC in *Canada Trustco* and *Mathew* can be summarized as follows:

1. There are three requirements which must be established in order to permit the application of the GAAR:

   (1) there must be a *tax benefit* resulting from a transaction or part of a series of transactions;

   (2) the transaction must be an *avoidance transaction* in the sense that it cannot be said to have been reasonably undertaken or arranged primarily for a *bona fide* purpose other than to obtain a tax benefit; and

   (3) there must be *abusive tax avoidance* in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer to obtain the tax benefit.

2. The burden is on the taxpayer to refute (1) and (2), and on the Minister to establish (3). It is typically under the third requirement that the dispute takes place.

3. If the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.

4. The courts are to conduct a "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 *Income Tax Act* that confer the tax benefit, read in the context of the whole statute.

5. Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations. However, any finding in this respect would be insufficient by itself to establish abusive tax avoidance.

6. 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.

A Win for the Taxpayer – *Canada Trustco*

In *Canada Trustco*, the taxpayer (“CTMC”) carried on business as a mortgage lender, and as part of its business operations, it obtained large revenues from leased assets. CTMC purchased a number of trailers which it then circuitously leased back to the vendor in order to offset revenue from its leased assets by claiming a substantial capital cost allowance (“CCA”) on the trailers. This arrangement allowed CTMC to defer paying taxes on the amount of profits reduced by the CCA deductions, which would be subject to recapture into income when the trailers were disposed of at a future date. The CRA disallowed the CCA claim by invoking the GAAR on the basis that CTMC had no economic risk in owning the trailers due to the pre-payment of all amounts due during the term of the lease.

However, the SCC agreed with the taxpayer. It held that the transaction was not so dissimilar from an ordinary sale-leaseback arrangement as to take it outside the object, spirit or purpose of the CCA provisions. The SCC held that the purpose of the CCA provisions, as applied to sale-leaseback transactions, was to permit the deduction of a CCA based on the cost of the assets acquired. The CRA’s suggestion that the usual result of the CCA provisions should be overridden by the GAAR in the absence of real financial risk in the transaction was rejected since the applicable CCA provisions do not refer to economic risk. According to the SCC, where Parliament has wanted to introduce economic risk into the meaning of cost related to CCA provisions, it has done so expressly.

A Win for the CRA – *Mathew et al.*

In *Mathew et al.*, Standard Trust Company (“STC”) carried on a business which included the lending of money on the security of mortgages on real property. STC became insolvent and a liquidator was appointed. At that time, STC owned a portfolio of 17 non-performing loans with 9 underlying real estate properties having a fair market value of approximately $33 million. The cost to STC of these “Portfolio Assets” was approximately $85 million. Since STC was being liquidated, it could not use the approximately $52 million in unrealized losses from the Portfolio Assets. The liquidator devised and oversaw the execution of a series of transactions to realize maximum returns on the disposal of the Portfolio Assets. The overall arrangement involved three stages whereby STC attempted to transfer these unrealized losses to a limited partnership and preserve their use through the application of s. 18(13) of the *Income Tax Act*. The appellant taxpayers became limited partners in the structure and claimed their proportionate shares of the losses from the eventual sale or write-down of the mortgaged properties. Relying on a combination of s. 18(13) and the partnership provisions of the *Income Tax Act*, they deducted over $10 million of STC’s losses against their own incomes. The CRA applied the GAAR to disallow the deduction.

The SCC agreed with the CRA. It held that to allow the taxpayers to claim the losses in this case would defeat the purposes of s. 18(13) and the partnership provisions. They do not permit arm’s length parties to purchase tax losses and claim them as their own. The purpose of s. 18(13) is to transfer a loss to a non-arm’s length party in order to prevent a taxpayer who carries on a business of lending money from realizing a superficial loss. The purpose of 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. Subsection 18(13) preserves and transfers a loss on the assumption that it will be realized by a taxpayer who does not deal at arm’s length with the transferor. The combined effect of the partnership rules and s. 18(13) is not intended to preserve and transfer a loss to be realized by a taxpayer who deals at arm’s length with the transferor. As a result, the use of these provisions to preserve and sell an unrealized loss to an arm’s length party was found to be abusive tax avoidance under the GAAR.

Conclusion

The SCC’s recent pronouncements on the GAAR have been very well received by the tax community. They are well reasoned and set a high bar for the successful use of the GAAR by the CRA, which is consistent with the spirit of the rule. However, rest assured that the CRA will continue to use the GAAR to combat aggressive tax planning.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation. If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact

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