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Hallmarks of Abusive Transactions and the Role of Economic Substance: Comments on Modernizing and Strengthening the General Anti-Avoidance Rule Consultation Paper

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1. Introduction

I support the initiative to revisit the GAAR for purposes of making it more effective. I find the Modernizing and Strengthening the General Anti-Avoidance Rule Consultation Paper ("GAAR Consultation Paper")[1] helpful in providing some background and context for diagnosing the issues and setting out some proposed solutions. I appreciate the opportunity to offer some comments on two specific questions raised in the Consultation Paper:

(a) How to clarify the object, spirit and purpose of provisions of the Act?
(b) What is the role of economic substance in strengthening the GAAR?

These questions are the most important in reforming the GAAR as they help identify abusive avoidance transactions – the target of the GAAR. Under section 245 of the Income Tax Act (the Act), an avoidance transaction is, in effect, disregarded or recharacterized for tax purposes only if it can be reasonably considered to result in a misuse or abuse of the pertinent provisions. According to the GAAR jurisprudence, the misuse or abuse test is based on whether the tax results are consistent with the object, spirit and purpose of the pertinent tax provisions (also known as legislative purpose or rationale). In more simple terms, the abuse test asks the question: was allowing the tax benefit the purpose or intent of Parliament in enacting the provisions? This question is the real GAAR question. Parliament has not provided much guidance on how to answer this question.

I offer the following main comments:

(a) The best way of clarifying the object, spirit or purpose of the provisions of the Act (as well as Income Tax Regulations or tax treaties) is to add an interpretive guidance provision (e.g., subsection 245(4.1)). It will describe a non-exhaustive list of circumstances and factors to be considered by the courts in the abuse analysis.
(b) It is very difficult to draft an explicit and clear economic substance rule. Even if such rule can be drafted, it is likely a poor proxy for the real GAAR question as it focuses on the taxpayer's purpose for entering into the transaction as opposed to Parliament's purpose in enacting the provision. It also has limited application as many provisions do not contemplate transactions to have meaningful economic effect or profit. Examples are tax incentive provisions. Economic substance can be included as one of the hallmarks of abusive transactions.
(c) In drafting the interpretive guidance provision, Canada can benefit from the best practices in other countries, such as the United Kingdom (UK), India, South Africa and Australia. These countries share a common judicial tradition with Canada (e.g., following the *Inland*

[1] Government of Canada, August 9, 2022, available at https://www.canada.ca/en/department-finance/programs/consultations/2022/general-anti-avoidance-rule-consultation.html

Revenue Commissioners v. Duke of Westminster[2]*)* and use the GAAR to counter the influences of this case. The UK model is particularly helpful to Canada.

2. The Real GAAR Question: Was the Claimed Tax Benefit Intended by Parliament?

The Supreme Court of Canada has interpreted the misuse and abuse test to require a determination of the object, spirit and purpose of the pertinent provisions through a textual, contextual and purposive interpretation of such provisions (*Canada Trustco*[3] and *Copthorne*[4]). If allowing the claimed tax benefit would otherwise frustrate or defeat Parliament's purpose, the transaction producing the tax benefit is abusive.

Was the tax benefit intended by Parliament in enacting the pertinent provisions? This is a hard question. The Act is a kaleidoscopic tapestry of interlocking rules, which Parliament periodically revises. Because Parliament has not explicitly stated its intent or purpose in enacting the provisions relied upon by the taxpayer to generate the tax benefit, it is up to the courts to find such intent or purpose by "going behind the words of the legislation".[5] This statutory interpretation exercise is challenging for various reasons, including:

- Parliament has different intent or purposes in enacting different types of provisions. In general, the taxing provisions are intended to measure income (or the ability to pay) in order to determine the amount of tax liability. On the other hand, tax incentives provisions are intended to encourage taxpayers to enter into transactions that they may not otherwise do in order to minimize their tax liability. The intent and purpose of specific anti-avoidance rules (SAARs) are linked to what is being otherwise avoided (i.e., a taxing provision or a tax incentive provision).

- Some legislative schemes, such as the capital cost allowance (CCA) scheme, contain all three types of provisions: a basic provision (e.g., s.20(1)(a)), a SAAR (e.g., the specified leasing property rules) and a tax incentive (e.g., a carved out for trailers from the SAAR).[6]

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[2] [1936] A.C. 1 (HL).

[3] *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54.

[4] *Copthorne Holdings Ltd. v. Canada,* 2011 SCC 63.

[5] *Copthorne*, para.66.

[6] See Jinyan Li, "The Misuse or Abuse Exception: The Role of Economic Substance" in B.J. Arnold, ed., *The General Anti-Avoidance Rule: Past, Present and Future* (Canadian Tax Foundation, 2021), 295-325.

- The intent and purpose of pertinent provisions may appear to be conflicting or lacking in cases where provisions in different legislative schemes were used "creatively" by taxpayers in obtaining a tax benefit (e.g., the transactions in *Kaulius*[7]).

- Through enacting the GAAR, Parliament, in effect, mandates a purposive interpretation approach, thereby requiring a shift in judicial approach to tax avoidance.

To help address this hard question, Parliament can offer some guidance. However, Parliament cannot rewrite existing provisions or clarify its intent or purpose of each existing provision through the GAAR. In other words, the object, spirit or purpose of pertinent provisions can be "clarified", but not "created" through the GAAR.

There are two models for Canada to consider in providing more legislative guidance on abuse: the UK model that defines "abusive tax arrangements", and the US model that codifies the judicial economic substance doctrine. I recommend the UK model as it is more of an "organic fit" with the Canadian tax system.

3. Legislative Guidance on Identifying Abusive Transactions – The UK Model

3.1 The UK GAAR

The UK GAAR was introduced in 2013 and applies to tax arrangements that are abusive. [8]Unlike the Canadian GAAR, the UK legislation is more explicit about identifying abuse. Subsection 207, Part 5, Finance Act 2013 reads as follows:

> (2) Tax arrangements are "abusive" if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances including—
>
> a. whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions,
> b. whether the means of achieving those results involves one or more contrived or abnormal steps, and
> c. whether the arrangements are intended to exploit any shortcomings in those provisions.

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[7] *Mathew v. Canada,* 2005 SCC 55 (sub nom *Kaulius).*

[8] *See Glen Loutzenhiser*, "The United Kingdom's General Anti-Abuse Rule" in B.J. Arnold, ed., *The General Anti-Avoidance Rule: Past, Present and Future* (Canadian Tax Foundation, 2021), 649-670.

(3) Where the tax arrangements form part of any other arrangements regard must also be had to those other arrangements.

(4) Each of the following is an example of something which might indicate that tax arrangements are abusive—

(a) the arrangements result in an amount of income, profits or gains for tax purposes that is significantly less than the amount for economic purposes,
(b) the arrangements result in deductions or losses of an amount for tax purposes that is significantly greater than the amount for economic purposes, and
(c) the arrangements result in a claim for the repayment or crediting of tax (including foreign tax) that has not been, and is unlikely to be, paid,

but in each case only if it is reasonable to assume that such a result was not the anticipated result when the relevant tax provisions were enacted.

(5) The fact that tax arrangements accord with established practice, and HMRC had, at the time the arrangements were entered into, indicated its acceptance of that practice, is an example of something which might indicate that the arrangements are not abusive.

(6) The examples given in subsections (4) and (5) are not exhaustive.

The above provisions are not prescriptive or exhaustive but offer specific guidance on how to determine abuse.

3.2 Anchored in "Relevant Tax Provisions"

Whether a tax arrangement is abusive is tested against the "relevant tax provisions": an arrangement is abusive if it cannot be reasonably regarded as a "reasonable course of action" in relation to the relevant tax provisions. This is consistent with the Supreme Court of Canada's approach to the extent that abuse is established when the object, spirit or purpose of the pertinent provisions is defeated or frustrated.

Section 207(2) of the UK legislation instructs the consideration of "all the circumstances", including three that have some counterparts in Canadian GAAR jurisprudence:

- Inconsistency with tax principles or policy objectives of the relevant tax provisions. In *Copthorne,*[9] the Supreme Court of Canada reiterated what was established in *Canada Trustco:* abuse is found if the transaction "achieves an outcome the statutory provision was intended to prevent" or "defeats the underlying rationale of the provision". In *Triad Gestco Ltd.*,[10] Noel J.A. found the paper loss generating transactions were abusive as the

[9] *Copthorne,* para.72

[10] 2012 FCA 258.

capital gains tax provisions "aimed at taxing increases in "economic power" and "economic power" is unaffected by paper losses.[11]

- Contrived or abnormal steps. In *Kaulius*, the Supreme Court of Canada found the vacuity and artificiality of transactions confirmed the abusive nature. In *Copthorne,* the Supreme Court of Canada took note of the transactions that artificially preserved the paid-up capital in a way that frustrated the purpose of s.87(3) of the Act. In *Global Equity*, the Federal Court of Appeal compared the loss-generating transactions to pulling the proverbial rabbit out of the magician's hat.
- Exploitation of legislative shortcomings. The GAAR is not meant to fix legislative loopholes. However, when pertinent tax provisions are interpreted contextually and purposively, the apparent legislative "loopholes" may not exist. As such, the transactions can be found abusive. For example, in *Oxford Properties,*[12] the Federal Court of Appeal found that a legislative ambiguity, which was clarified by subsequent legislation, could not be used by the taxpayer to avoid "latent recapture" on the depreciable property held by the partnerships on the ground that such result would frustrate the object, spirit and purpose of the pertinent provisions (s.88(1)(c) and (d) and s.98(3)).

3.3 Hallmarks of Abuse

The UK legislation gives three examples of how the definition of abusive arrangements will be applied in practice. The first two examples are more relevant to measuring income for purposes of applying taxing provisions and are discussed in more detail below. The third example is more specific in respect of tax refund or credits – if the tax has not been or is unlikely to be paid, then the arrangements that result in the claim for refund or credit are abusive. This third example does not have much relevance to reforming the Canadian GAAR.

The first two examples show a comparative exercise: comparing the amount for tax purposes and the amount for economic purposes. If the tax amount of income, profits or gains is "significantly less" than the economic amount or the tax amount of deductions or losses is "significantly greater" than the economic amount, the arrangements generating such amount is assumed to be abusive. The idea behind these examples appears to be similar to the "pre-tax profit" test in the US economic substance doctrine (see below), but the UK legislation is more broadly worded. The UK legislation does not prescribe a method for comparison or require a comparison of "tax savings" and pre-tax profit. It does not use the term "economic substance".

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[11] *Triad Gestco Ltd,* para.42.

[12] 2018 FCA 30

Canadian GAAR jurisprudence does not accept "economic substance" as relevant in isolation from the pertinent provisions.[13] A comparison of the taxpayer's situation with an alternative arrangement may be relevant to determining if there is a tax benefit resulted from a transaction, but not relevant to the abuse test.

Through section 207(2) and section 207(4), Parliament implicitly says the following. First, there are tax principles and tax policy objectives embedded in the relevant tax provisions and the tax results of taxpayer's transactions should be consistent with these principles or objectives to be safe from the GAAR. Next, Parliament did not intend the pertinent tax provisions to apply to transactions that contain contrived or abnormal steps. Tax-motivated transactions are examples of such transactions. Finally, not all legislative shortcomings can be exploited by taxpayers.

The UK legislation does not turn the GAAR into a prescriptive rule or inject a new line of inquiry that deviates from statutory interpretation. While comparing the economic results and tax results is relevant, the abuse analysis is not about economics or merely the amount of pre-tax profit.

3.4 Relevance for Canada

The UK approach is highly relevant for Canada.[14] Both the Canadian GAAR and the UK GAAR explicitly refer to abuse. Canada and the UK share some common judicial culture, common law interpretation of basic tax law concepts, and legislative drafting style. Adopting the UK model will not require any disruptive change in the GAAR jurisprudence.

Adding a new provision to section 245 would have the benefit of enhancing certainty and predictability while protecting the integrity of the tax law and policy. It would not require a major shift in Canadian jurisprudence on abuse, which is already anchored in finding the legislative purpose of the pertinent provisions and considers the vacuity and artificiality of transactions relevant indicators of abuse. It can, in effect, place a higher burden on the taxpayer to show why avoidance transactions lacking meaningful economic effect were consistent with legislative purpose.

In terms of lineage or general thinking about abuse, the circumstances and examples described in the UK GAAR can be said to capture the object, spirit and purpose of provisions of the Act read as a whole. Even though the word "abuse" was added to the Act as part of the GAAR in 1988, the idea behind the notion of anti-abuse (that is, Parliament's intent to protect the tax base from taxpayers' "artful" use of legal forms and legal fictions) can be gleaned from the history of the Act. Examples include: the 1917 Income War Tax Act (s. 3(2)), the 1938 Income War Tax Act (s.32A and

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[13] *Canada Trustco,* paras. 45, 60, 76.

[14] For similar views, see Scott Wilkie, "Hiding in Plain Sight? Changes to "Transfer Pricing" and the GAAR", https://tax.osgoode.yorku.ca/2021/06/hiding-in-plain-sight-changes-to-transfer-pricing-and-the-gaar/

s.32B), the 1948 Income Tax Act (s.137), the 1952 Income Tax Act (s.138A), and the 1972 Income Tax Act (s.245 and s.246). These anti-avoidance rules tease out the indicators of unacceptable transactions from Parliament's perspective, including: "abnormal" relationship between the parties to a transaction, such as related parties or non-arm's length parties; "artificial" transactions; transactions that do not reflect fair market value (i.e., abnormal in respect of the amount of the transfer price); the use of corporate form to defer shareholder-level tax or minimise shareholder-level tax through dividend strips.

Of course, the meaning of "contrived", "abnormal", "artificial" or "vacuity" is not self-evident. But, interpreting these concepts falls squarely within the competency of the courts. Parliament has no institutional advantage in this respect and should let the courts do their job. Parliament has generally left it to the courts to define the meaning of basic concepts, such as "income", "residence", "reasonable", "fair market value", etc. "The GAAR is a living rule".[15] So are other provisions of the Act. The common law complements statutory law in ensuring the meaning of key concepts is not cut in stone.

4. Codified Economic Substance – the US Model

4.1 The Economic Substance Doctrine

In 2010, the United States Congress codified the economic substance doctrine in section 7701(o) of the Internal Revenue Code. This provision reads as follows:

> *Clarification of economic substance doctrine.*
>
> (1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
>
> > (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> >
> > (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.
>
> (2) Special rule where taxpayer relies on profit potential.
>
> > (A) In general. The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the

[15] GAAR Consultation Paper, heading "A. Introduction".

> transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.
>
> (B) Treatment of fees and foreign taxes. Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

(3) State and local tax benefits. For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) Financial accounting benefits. For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) Definitions and special rules. For purposes of this subsection—

> (A) Economic substance doctrine. The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.
>
> (B) Exception for personal transactions of individuals. In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.
>
> (C) Determination of application of doctrine not affected. The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.
>
> (D) Transaction. The term "transaction" includes a series of transactions.

Section 7701(o) supplements, but does not supplant, the judicial economic substance doctrine. It is titled "clarification" of the doctrine. It applies "in the case of any transaction to which the economic substance doctrine is relevant". Section 7701(o)(5)(C) says that "the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if section 7701(o) had never been enacted."

The judicial economic substance doctrine was developed in three landmark cases. It was originated in *Gregory v. Helvering* (1935),[16] expanded in *Knetsch v. United States* (1960)[17] and conceptualized in *Frank Lyon Co. v. United States* (1978).[18] These cases stand for the general principle that mere compliance with the wording of the tax provisions will not automatically entitle a taxpayer to the claimed tax benefits. *Gregory* recognizes the right of taxpayers to minimize taxation, but emphasizes a purposive interpretation of the tax provisions:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.[19] (emphasis added)

Knetsch required transactions to "meaningfully change the taxpayer's economic position". *Frank Lyon* extracted those two principles and articulated the first economic substance doctrine. Subsequent cases adopted various approaches to applying the purpose test and the substantive result test and could not agree whether both tests must be test for the economic substance doctrine to apply.

The codification was intended to unify the different judicial approaches to applying the doctrine. First, the doctrine must be relevant to the transaction, implying that economic substance is not relevant in all tax avoidance transactions. The doctrine requires "disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality."[20]

Next, Section 7701(o) requires a two-prong conjunctive test to be met:

- The a transaction must result in a "meaningful" change in the taxpayer's economic position (apart from Federal income tax effects) (known as the "economic substance", "pre-tax profit" or "economic effect" test).[21]
- The taxpayer has a "substantial" business purpose (apart from Federal income tax effects) for entering into the transaction (this is referred to as the "business purpose test").

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[16] 293 U.S. 465 (1935).

[17] 364 U.S. 361 (1960).

[18] 435 U.S. 561 (1978).

[19] *Gregory v. Helvering,* 293 U.S. at 469.

[20] *Coltec Industries, Inc. v. United States,* 454 F.3d at 1352.

[21] This test does not refer to the contrived or artificial nature of the transactions, although in practice, it has been relevant mostly in tax shelter cases.

Failing the economic substance test will result in not only the denial of a claimed tax benefit, but also a 20% strict liability penalty (40% in the case of undisclosed transactions) on any underpayment attributable to the disallowed tax benefit claimed.

Congress acknowledged that this doctrine should be applied sparingly. The Joint Committee on Taxation issued a report prior to the enactment of the doctrine, in which it provided detailed guidance on when the doctrine should apply.[22] The Internal Revenue Service (IRS) has issued guidance and put in place detailed procedures for examiners to follow in determining whether to assert the doctrine. Some transactions were immunized from section 7707(o), including: corporate formations; choosing between debt or equity to capitalize a business entity; the choice between a domestic or foreign corporation for foreign investment; structuring of a corporate reorganisation; and use of a related entity in a transaction. [23]

4.2 Economic effect -- "Meaningful Change in a Taxpayer's Economic Position"

This test involves the determination of whether the transaction actually changes the taxpayer's economic position, and if so, whether the change is "meaningful". It does not require a showing of a profit motive or objective. It is an objective test.

In many aggressive tax-motivated avoidance cases, the taxpayer's financial position has not changed at all, or only negligibly. Thus, the court did not need to determine whether the change in economic position was meaningful. The *Gregory* case is an example. The taxpayer's economic position did not change when she transferred one thousand shares of stock in Monitor to a newly-formed corporation only to receive the same Monitor shares four days later when the new corporation was liquidated. The value of the shares remained the same at the time of the transfer and upon liquidation.

Profit potential or pre-tax profit is relevant to determining a change in economic position but is not the only factor. Lacking a profit potential does not automatically render a transaction to fall within section 7701(o). This is particularly the case with tax incentive or tax relief provisions.

However, the taxpayer may choose to rely on potential for profit to show the transaction meets the economic effect prong of the doctrine. Under section 7701(o)(2)(A), the test is met only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in

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[22] See, Staff of the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act,"* JCX-18-10 (Mar. 21, 2010), pp.142-156, http://www.jct.gov/publications.html?func=startdown&id=3673; US Senate Committee on Finance, "Economic Substance Doctrine" (2010), https://www.finance.senate.gov/imo/media/doc/Leg%20110%20100407agamendment.pdf

[23] I.R.S. Notice 2010-62, 2010-2C.B. 411.

relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. This provision functions as a safe harbour. Because this rule compare pre-tax profits to tax benefits, it does not focus only on the amount of profit potential or lack thereof. Therefore, it is possible that a transaction that offers a healthy pre-tax rate of return but even greater tax benefits can satisfy the test.[24]

What constitutes a "meaningful change" depends on the facts and circumstances of each case. There is no legislative guidance. The amount of pre-tax profit can range from trivial to substantive and there is no logical limitation on the amount of pretax profit required. Any fixed line would ignore the fact that the capital markets will take preferential tax treatment into account in setting relative prices. Some post-codification cases applied the comparative test in section 7701(o)(2)(A). A "high ratio of tax benefits to maximum potential profit indicates that the transactions were designed only to produce disproportionate tax benefits".[25]

4.3 "Substantial Business Purpose"

The second prong of the codified economic substance rule speaks to the taxpayer's intent or purpose. The provision does not define what constitutes a substantial purpose.

The jurisprudence suggests that transactions tied to ordinary business operations are favorably treated under this test. For example, in *UPC v. Commissioner,*[26] the court stated that a "transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business." In *Black & Decker Corp. v. United States*[27] the court said that "a corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions." The judicial interpretation of the business purpose test leans towards respecting transactions closely tied to a business, such as purchasing a bank building in *Frank Lyon* or restructuring an existing income stream arising from the core business of shipping packages in *UPS.* As such, as long as tax shelters are built into an existing business as opposed to being "a

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[24] For discussion of US cases on this point, see Alvin C. Warren, Jr., "The Requirement of Economic Profit in Tax Motivated Transactions", 59 *Taxes* 985 (1981); Joseph Bankman, "The Economic Substance Doctrine", 74 *Cal. L. Rev.* 5 (2000); Monica D. Armstrong, "OMG-ESD Codified: The Overreaction to Codification of the Economic Substance Doctrine," 9 *Fla. A &M U. L. Rev.* 113 (2013).

[25] *K2 Trading Ventures, LLC v. United States, 101* F.3d CI. 365 at 382 (2011); *Jade Trading, LLC. V. United States,* 598 F.3d 1372 (2010).

[26] *United Parcel Serv. Of Am., Inc. v. Commissioner*, 254 F.3d (11th Cir., 2001) at 1019.

[27] 340 F. Supp.2d 621, at 623-4 (D. Md. 2004).

hokey portfolio add-on with no separate justification for its existence", they will likely be considered to have a business purpose.[28]

4.4 Drawbacks

The doctrine has been criticized for having several major drawbacks, including: as a poor proxy for identifying abuse; being prone to taxpayer's control of evidence; and not relevant to addressing tax avoidance involving tax incentive provisions.[29]

First, the economic substance doctrine has shifted the inquiry from Congress' intent or purpose to taxpayer's purpose and result. This shift occurred in *Frank Lyon* and now codified. It does not answer the real question – whether Congress intended the claimed tax result. "Unless the statute provides a result that hinges on the taxpayer's intent, Congress's intent will not vary with the taxpayer's state of mind."[30]

The business purpose test in section 7701(o) is different from the business purpose test in *Gregory*. In *Gregory*, Judge Learned Hand, whose reasoning was affirmed by the Supreme Court, was talking about the business purpose implied in the reorganization rules, not the business purpose of the transaction. He explained that the corporate reorganization itself – that is, the form in which the transaction was carried out –had to be germane to the business of one corporation or the other:

> The purpose of the section is plain enough; men engaged in enterprises –industrial, commercial, financial, or any other—might wish to consolidate, or divide, to add to, or subtract from, their holdings. … But the underlying presumptions is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution.[31]

In affirming Learned Hand's decision, the Supreme Court found that Congress implicitly required a business purpose to qualify under the reorganization statute in issue.

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[28] Lee Sheppard, "Bury Your Tax Shelter in a Business," 106 *Tax Notes* 20 at 22 (2005).

[29] There is a body of literature on the economic substance doctrine. See, for example, Joseph Bankman, "The Economic Substance Doctrine," 74 *Cal.L. Rev.* 5 (2000); A. Bennett, "Codification Would Create More Problems Than It Solves, Says Korb," 118 *Tax Notes Today* 777 (Feb.18, 2008); S. Desloge, "Clarify or confusion?: The Common Law Economic Substance Doctrine and Its Statutory Counterpart," 46 *J. Legis.* 326 (2019); Leandra Lederman, "(W)hiter Economic Substance," 95 *Iowa L. Rev.* 389 (2009); D.P. Hariton, "Sorting out the Tangle of Economic Substance," 52 *Tax Law* 235 (1999); J.P. Houchens, "Per Se Economic Substance," 2018 *BYU L. Rev.* 157 (2018).

[30] Lederman, ibid., at 433.

[31] *Helvering v. Gregory,* 69 F.2d 809, at 811 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

In *Frank Lyon,* however, the Supreme Court shifted the focus from Congress to the parties. The Court upheld the taxpayer's treatment of a sale-in/lease-out transaction, stating as follows:

> [W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the Parties." [32]

Second, the focus on taxpayer's intent and economic results encourages taxpayers to generate evidence to satisfy the two tests. In *Frank Lyon*, the Court considered 26 factors. Taxpayers can generate evidence of a business purpose, including relying on non-tax regulatory requirements (such as compliance with Federal Reserve requirements in *Frank Lyon*).[33]

Third, the meaningful change in the taxpayer's economic position test does not test whether the claimed tax benefits are consistent with the underlying economics of the transaction –an inquiry that could help elucidate whether the tax results are consistent with Congress' intent. Instead, it focuses on the very different question of whether the transaction altered the taxpayer's pre-tax economic position in a meaningful way. The safe harbour of comparing pre-tax benefits to tax savings can be uncertain as there is no single place to draw the line between "substantive" and "non-substantive".

Finally, the economic substance doctrine is not apt to capture transactions designed to take advantage of tax incentive provisions or legislative shortcomings. For example, in *Summa Holdings v. Commissioner*[34] the IRS invoked the substance-over-form doctrine as opposed to economic substance doctrine This case involved a family using a DISC (a domestic international sales corporation) and a Roth IRA to transfer money from its family business to Roth IRAs owned by the children. Congress used DISCs to incentivize companies to export their goods by deferring and lowering taxes on export income. Roth IRAs are tax-deferred vehicles to encourage retirement savings. The IRS relied on the substance-over-form doctrine to recharacterize the transactions and disallow the tax benefits. Economic substance was not relevant to the transactions at issue. The Court held that Congress enacted these tax incentives but did not specify how taxpayers should or should not go about export activities or make investment in order to qualify for the intended

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[32] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

[33] This point has some resemblance in Canada. As stated in the GAAR Consultation Paper, Canadian courts considered creditor-proofing purpose as an acceptable bona-fide non-tax purpose in *Swirsky v. The Queen* (2013 TCC 73, affirmed 2014 FCA 36) and *McClarty Family Trust v. The Queen*, 2012 TCC 80.

[34] *Summa Holdings, Inc*. CA-6, 2017-1 USTC, 50155, 848 F.3d 779.

tax benefits. The Court did not take it upon itself to fill in the legislative gaps. The claimed tax benefits were allowed.

4.5 Ill-suited for Canada

The US model is ill-suited for Canada because the tax culture is different. While the Canadian judiciary has embraced the *Duke of Westminster* principles (literal interpretation of tax provisions and rejection of substance-over-form doctrine), US courts have adopted a purposive approach to statutory interpretation and anti-abuse doctrines, including economic substance, even though the US courts recognize taxpayer's right to minimize taxes.[35] For example, the purchase and lease-back transactions in *Altria Group Incorporated v. United States*[36] are similar to those in *Canada Trustco*. The US court relied on substance-over-form doctrine to deny the depreciation deduction to the "lessor" on the ground that it did not have genuine ownership of the depreciable assets because the lessee had control of the assets and bore most of the risks. The court took into account of factors such as the defeasance accounts, circularity of the parties' obligations, actual control, risk and the involvement of tax-indifferent third parties. The court said that "to permit the true nature of a transaction to be disguised by mere formalism, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."[37]

Legislating economic substance in Canada would require a shift in judicial thinking, which generally rejects the substance-over-form approach or recharacterizing transactions based on economic reality.[38]

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[35] *Gregory v. Helvering,* 69 F.2d 810 (2d Cir. 1934), aff'd 293 U.S. 465 (1935) (Judge Learned Hand):

> We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

[36] *Altria Group, Inc. v. United States,* 694 F. Supp. 2d 259 (S.D.N.Y. 2010).

[37] Ibid.

[38] E.g., *Shell Canada Ltd v. Canada* [1999] 3 SCR 622.

5. Role of Economic Substance in Strengthening the GAAR

5.1 Identifying the Issue

I am sympathetic to the statement in the Consultation Paper that the "GAAR does not sufficiently take into consideration the economic substance of transactions." The deficiency is more notable in regard to applying subsection 245(4).

Section 245(3) does take into consideration the business purpose of transactions as part of the "primary bona fide non-tax purpose" test. Based on the GAAR jurisprudence, this test seems to have worked reasonably well. It is unclear whether an explicit reference to a substantive business purpose will help clarify anything. The transactions in *Canada Trustco* were found to be "avoidance transactions" under the existing provision.

With respect to the abuse analysis under subsection 245(4), a case can be made that an explicit reference to the economic effect (or pre-tax profit test) of transactions may be helpful. In *Canada Trustco,* the Court made problematic statements about the role of economic substance, even though it was not entirely incorrect to say that the relevance of economic substance is determined by reference to the pertinent provisions. It is unfortunate that the Court has not had an opportunity to revisit the role of economic substance in subsequent cases. In *Lipson, Copthorne* and *Alta Energy*, an economic substance analysis would not be relevant as the pertinent provisions of the Act or tax treaty cannot be said to contemplate any pre-tax profit as a precondition for receiving the tax benefit. In cases where the pertinent provisions were intended to apply to income or loss from an economic perspective (or having an air of economic reality), the Federal Court of Appeal took this into consideration in *Global Equity* and *Triad Gestco.*

There is room for improving the current situation by clarifying that the economic effect or reality of transactions is relevant in determining the abuse of some provisions, especially those related to measuring income.

5.2 Defining Economic Substance

It would be helpful to clarify the meaning of economic substance. Economic substance is not a term that has a clear meaning in existing law (statutory or case law). The Act does not contain this term and rarely refers to "economic profit" (e.g., s.126(4.1)). Case law occasionally refers to "economic substance" (e.g., *Canada Trustco*) or "economic realities" (*Shell Canada, Global Equity; Singleton*), but offers no definitions.

The US economic substance doctrine includes a business purpose test and an economic effect or substance test. The GAAR in Australia, India, and South Africa also capture both the purpose and effect of the transaction. The UK GAAR refers to the amount of income or loss, thus an outcome-based and comparative test.

If an economic substance test were to be added to the Canadian GAAR, since the business purpose prong is already encompassed by subsection 245(3), only the economic effect prong needs to be included in the definition.

5.3 Incorporating the economic substance test into the GAAR

The Consultation Paper proposes some ways of incorporating economic substance into the GAAR. I briefly comment on some of the proposals.

5.3.1 A "clear and explicit" rule?

The U.S. experience suggests that there is nothing clear, explicit or certain about the economic substance doctrine: the meaning of "substantial business purpose" or "meaningful change in economic position" is inherently facts-driven and thus defies a workable arbitrary definition.

If Canada were to add the economic effect test to the GAAR, this new test will likely be difficult to design and uncertain in its application.

5.3.2 The substantial business purpose in defining "avoidance transaction"?

The "sole", "dominant" or "substantial" business purpose test is already covered by the existing s.245(3). The economic profit test should not be incorporated into the avoidance transaction determination under subsection 245(3) as it may narrow the scope of avoidance transactions, thereby undermining the purpose of this provision.

5.3.3 Lacking Economic Profit as a Hallmark of Abusive Transactions?

It is impossible for Parliament to clarify which provision of the Act was intended to apply to transactions with substantive economic substance. Parliament can, however, flag that economic substance was expected in certain circumstances and leave it to the courts to determine what these circumstances are. It can achieve this goal by including economic profit test as one of the indicators of abusive transactions.

I would not recommend introducing a separate deeming rule beyond the new provision on hallmarks of abusive transactions.

5.4 Learning from Other Countries

The GAAR provisions in UK, India, South Africa and Australia recognize the relevance of economic substance (in the sense of economic result, business profits, pre-tax profit, or commercial substance) as a factor in identifying abuse. None of these GAARs elevate the economic substance test as an automatic abuse test.

5.4.1 India

The Indian GAAR was introduced in 2012. It includes a lack or deemed lack of commercial substance in whole or in part as one of the factors to taint a transaction for GAAR purposes.

Section 96 of the Income Tax Act, 1961-62[39] defines "impermissible avoidance arrangement" as follows:

> 96. (1) An impermissible avoidance arrangement means an arrangement, the main purpose of which is to obtain a tax benefit, and it—
>
> (a) creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;
>
> (b) results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;
>
> (c) lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or
>
> (d) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes.
>
> (2) An arrangement shall be presumed, unless it is proved to the contrary by the assessee, to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit.

Section 97 offers the following guidance on economic substance:

> 97. (1) An arrangement shall be deemed to lack commercial substance, if—
>
> (a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or
>
> (b) it involves or includes—
>
> (i) round trip financing;
>
> (ii) an accommodating party;
>
> (iii) elements that have effect of offsetting or cancelling each other; or

[39] India, Income Tax Act, 1961, https://www.incometaxindia.gov.in/Pages/acts/income-tax-act.aspx

(iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or which is the subject matter of such transaction; or

(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party; or

(d) it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this Chapter).

(2) For the purposes of sub-section (1), round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter),

without having any regard to—

(A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

(B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

(C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

(3) For the purposes of this Chapter, a party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

(4) For the removal of doubts, it is hereby clarified that the following may be relevant but shall not be sufficient for determining whether an arrangement lacks commercial substance or not, namely:—

(i) the period or time for which the arrangement (including operations therein) exists;

(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;

(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

5.4.2 South Africa

The South African GAAR in section 80A(a) of the Income Tax Act[40] identifies an "impermissible avoidance arrangement" by reference to two tainted elements: (a) it was entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit; or (b) it lacks commercial substance, in whole or in part, taking into account the provisions of Section 80C.

Section 80C provides a general rule for determining whether an avoidance arrangement lacks commercial substance for the purposes of s 80A, as well as a non-exclusive set of characteristics that serve as indicators of a lack of commercial substance. It reads as follows:

a. For purposes of this Part [the GAAR], an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party (but for the provisions of this Part) but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained but for the provisions of this Part.
b. For purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but are not limited to –
    i. the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps;
    ii. The inclusion or presence of –
        (i) round trip financing;
        (ii) an accommodating or tax indifferent party; or
        (iii) elements that have the effect of offsetting or cancelling each other.

"Round tripping" and "an accommodating or tax indifferent party" are defined in section 80D and section 80E respectively.

5.4.3 Australia

The Australian GAAR in Part IVA of the Income Tax Act[41] adopts a purpose test. Section 177(D)(1) says that the GAAR applies to a scheme if it would be concluded (having regard to the matters listed below) that the scheme was entered into or carried out for the purpose of enabling a relevant taxpayer to obtain a tax benefit. Section 177(D)(2) lists the factors relevant to applying the purpose test:

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[40] South Africa, Income Tax Act 58 of 1962, https://www.gov.za/documents/income-tax-act-29-may-1962-0000#:~:text=The%20Income%20Tax%20Act%2058,taxation%20of%20incomes%20and%20donations.

[41] Australia, Income Tax Assessment Act 1936, http://classic.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/

(a) the manner in which the scheme was entered into or carried out;
(b) the form and substance of the scheme;
(c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
(d) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
(e) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
(f) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
(g) any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out;
(h) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).

The Australian experience does not seem to suggest that the above list of factors, including the economic substance elements in (c), (d) and (e) play a meaningful role in improving certainty and predictability of the GAAR. The purpose test is considered to be flawed by some: 'Purpose' is the black box at the centre of most GAAR rules and GAAR disputes because purpose is a flawed and vexed criterion to employ."[42]

5.4.4 UK

The UK GAAR legislation instructs the court must take into account the amount of income or loss for economic purposes and tax purposes, which is similar to the comparison of pre-tax benefits and tax benefits in the United States.

As mentioned above, I think the UK model is elegant and suitable to Canada. The detailed legislative rules in Australia, India and South Africa seem to be too prescriptive and pivoted to the purpose of the wrong party – the taxpayer as opposed to Parliament.

5.5 Consequences of applying the economic substance rule

Where an avoidance transaction fails the economic profit test, it should not be automatically deemed abusive. Abuse should be found in cases where the pertinent provisions were intended to apply to transactions with economic profit. Tax incentive provisions and SAAR provisions may not require the existence of economic profit, and whether such provisions are abused will be determined by analyzing the claimed tax benefit falls within the legislative purpose.

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[42] Graeme Cooper, "The Role and Meaning of 'Purpose' in Statutory GAARs", https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2752276

If an avoidance transaction lacking economic profit is found to be abusive, the Minister has discretion to determine the "reasonable consequences", which may include disallowing all of the claimed tax benefit. There seems to be no need to make an explicit reference to economic substance in subsection 245(5).

The benefit of explicitly reversing the burden of proof rule through amending the GAAR is not clear to me. The GAAR is meant to be a measure of last resort and can be invoked only by the Minister. It seems logical that the Minister bears the burden of proof, although the interpretative guidance provision listing the hallmarks of abusive transactions can increase the burden of proof for the taxpayer.

5.6 Limited Application: The Example of *Canada Trustco*

My research on the US economic substance doctrine and the GAAR shows that what may be considered matters within the economic substance inquiry can be addressed without resorting to economic substance analysis. The *Canada Trustco* decision is an interesting example to explain this point.

The transactions in *Canada Trustco* were used as the basis for one of the three examples described in Annex B of the Consultation Paper. If Canada were to adopt the US model, the transactions are likely considered as lacking a "substantial business purpose" as the main purpose of the transactions was to create a tax shelter for profits from other lines of business. They may also fail the economic substance test because the pre-tax profit was not derived from the leasing transactions, but peripheral transactions – investment in government bonds. The amount of pre-tax profit from the purchasing and lease-back transaction is likely much less than the tax benefit. This would be the case in spite of the Court's reference to the Tax Court judge's finding that the transaction was a "profitable commercial investment" because the judge took into account of profit from the investment transaction.

The Court did not find abuse because, in simple terms, economic substance was not required by the capital cost allowance (CCA) provisions. It held that these provisions require merely "legal cost" and their purpose, "as applied to sale-leaseback transactions, was, … to permit deduction of CCA based on the cost of the assets acquired."[43]

The decision is problematic because of its flawed approach to statutory interpretation, not rejecting the relevance of economic substance. The Court's interpretation of the CCA provisions is highly textual. The *Copthorne* decision provides a more sophisticated framework for contextual and purposive interpretation. However, even using the *Copthorne* framework, one can argue that the basic CCA deduction provision (i.e., s.20(1)(a)) was not intended to require the existence of

[43] *Canada Trustco*, para.74.

pre-tax profit as a condition for claiming the deduction. Deductibility of cost outlays is determined by the purpose, as opposed to result, of the expenditure (e.g., s.9 of the Act and the rich body of jurisprudence). It is true that the deduction of cost requires some air of economic realities (see *Global Equity*) because income (or loss) is about measuring economic ability to pay tax and is, thus, an economic notion. But paying attention to the economic realities in determining the deductibility of cost (or loss) is not the same things as allowing the deduction only if the transaction has potential for pre-tax profit.

Without relying on any economic substance rule, abuse could be established in one of the following ways:

(a) Asking the real question – Was the claimed CCA deduction consistent with the purpose of the carve-out for trailers in the specified leasing property rules (which are in the nature of a specific anti-avoidance rule or SAAR)? The Court in *Canada Trustco* did not ask this question. It Court did not consider why sale-leaseback transactions involving trailers were carved out from the SAAR that deny the CCA deduction to the lessor, and focused, instead, on the general CCA scheme and the legal meaning of "cost".

Legislative history of the carve-out rule for trailers suggests that the purpose of this rule was to provide a subsidy to Canadian long-haul trucking businesses.[44] This purpose was defeated when a financial institution claimed the CCA in respect of trailers used by an American trucking company. An inquiry about the amount of pre-tax profit or substantial business purpose of the taxpayer is beside the point.[45]

(b) Asking a basic tax law question – Can a taxpayer deduct a cost of depreciable property without actually owning the property? What does ownership mean in private law? Can the taxpayer be considered to own the trailers when the original owner/lessee retained possession and bore all the costs and risks of ownership during the lease term? This is a legal question, not an economic inquiry. The court in *Altria* upheld the government's disallowance of the depreciation deduction by answering these questions without using the economic substance doctrine.

(c) Identifying the vacuity and artificiality of the steps used to generate the CCA deductions. This is not about pre-tax profit or economic profit, but whether any step in the interlocking

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[44] Li, supra note 6.

[45] In *Canada v. Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49, the Court asked this question and focused on the intent of the carve-out rule in a SAAR in Article 13(4) of the tax treaty. See Jinyan Li, "Finding the Purpose of Tax Treaty Provisions under the GAAR: Lessons from Alta Energy," (2022) 105:2 *Tax Notes Int'l* 147-61.

transactions has no meaning or effect other than help generating the tax results. This is the kind of consideration mandated by the UK GAAR in identifying abusive arrangements.

As the Consultation Paper points out, the *Canada Trustco* case also illustrates a challenge with the design of a pre-tax profit test – does the profit need to arise from the actual purchase-leaseback transactions that gave rise to the tax benefit? Also, how much pre-tax profit is sufficient?

6. Conclusions

In my view, the Canadian GAAR can be strengthened by adding some legislative guidance on identifying abusive transactions. Such guidance will help the courts conduct the abuse analysis under subsection 245(4). It can be modeled on the UK GAAR by listing the circumstances to be taken into account and providing some hallmarks of abusive transactions, such as the absence of economic profit or tax benefit dwarfing non-tax benefit.

Creating an economic substance rule is unnecessary if the above interpretive guidance provision is introduced. An economic substance rule is likely difficult to design and hard to apply. It will not be relevant in circumstances where the pertinent tax provisions were not intended to require economic substance. It will shift the abuse analysis from Parliament's intent or purpose to the taxpayer's, which deviates from the judicial approach that emphasized testing the tax results against the object, spirit and purpose of the pertinent provisions.