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## Economic Substance: Drawing the Line between Legitimate Tax Minimization and Abusive Tax Avoidance

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# “Economic Substance”: Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance

Jinyan Li\*

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## PRÉCIS

La règle générale anti-évitement (RGAE) de l'article 245 de la Loi de l'impôt sur le revenu permet de faire la distinction entre la réduction légitime de l'impôt et l'évitement fiscal abusif. La RGAE ne fournit cependant pas de lignes directrices pour déterminer si une opération particulière est légitime ou abusive. Dans cet article, l'auteur fait valoir que la réalité économique est utile pour faire cette distinction. Non seulement est-elle exigée par le législateur avec l'adoption de la RGAE, mais elle se justifie également par des motifs théoriques et est compatible avec la méthode textuelle, contextuelle et téléologique d'interprétation des lois. De plus, l'auteur croit que la réalité économique est la meilleure méthode pour équilibrer les préoccupations politiques conflictuelles dans la loi fiscale canadienne. La Cour suprême du Canada a également reconnu la pertinence de la notion de la réalité économique dans le récent arrêt *Hypothèques Trustco Canada*. Cependant, il s'agit d'une notion relativement nouvelle dans le droit fiscal canadien. Cet article nous permet de mieux la comprendre en traitant des quatre questions suivantes : 1) Pourquoi l'analyse de la réalité économique devrait-elle être pertinente dans les causes portant sur la RGAE ? 2) Qu'entend-on par « réalité économique » ? 3) Quels sont les facteurs pertinents pour déterminer la réalité économique d'une opération ? 4) Comment appliquer l'analyse de la réalité économique dans les causes portant sur la RGAE ?

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\* Of Osgoode Hall Law School, York University, Toronto, and senior researcher at the Policy Research Institute, Monash University, Melbourne. This article is based on a paper presented at a symposium held on November 18, 2005 at the University of Toronto, Faculty of Law, “The Supreme Court of Canada and the General Anti-Avoidance Rule: Tax Avoidance After *Canada Trustco* and *Mathew*.” (For a summary of the symposium proceedings and other commentary on these cases, see Policy Forum (2005) vol. 53, no. 4 *Canadian Tax Journal* 1007-52.) I thank Rick Krever, Daniel Sandler, and the anonymous reviewers for the *Canadian Tax Journal* for their comments on the draft of the article. I also thank Chief Justice Donald Bowman, Al Meghji, and other participants at the GAAR symposium on November 18, 2005 for their insightful remarks about economic substance in Canadian tax law. My special thanks go to Scott Wilkie, who has provided much inspiration for this article.

**ABSTRACT**

The general anti-avoidance rule (GAAR) in section 245 of the Income Tax Act is about drawing a line between legitimate tax minimization and abusive tax avoidance. However, the GAAR does not provide guidelines for determining whether a particular transaction is legitimate or abusive. In this article, the author argues that economic substance is a useful standard for drawing the line. It is not only called for by Parliament through the enactment of the GAAR; it is also justified on theoretical grounds, and is consistent with the textual, contextual, and purposive approach to statutory interpretation. Moreover, the author argues, economic substance is the best method for balancing conflicting policy concerns in Canadian income tax law. The Supreme Court of Canada also recognized the relevance of economic substance in the recent *Canada Trustco* decision. However, economic substance is a relatively new concept in Canadian tax law. The article advances our understanding of this concept by addressing four questions: (1) Why should economic substance analysis be relevant in GAAR cases? (2) What does “economic substance” mean? (3) What are the relevant factors in determining the economic substance of transactions? (4) How can an economic substance analysis be applied in GAAR cases?

**KEYWORDS:** ECONOMIC SUBSTANCE ■ GENERAL ANTI-AVOIDANCE RULE ■ TAX AVOIDANCE ■ STATUTORY INTERPRETATION ■ TAX SHELTERS

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## INTRODUCTION

Subsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the Act to avoid tax.<sup>1</sup>

The GAAR draws a line between legitimate tax minimization and abusive tax avoidance. The line is far from bright.<sup>2</sup>

While the “economic substance” of the transaction may be relevant at various stages of the [section 245] analysis, this expression has little meaning in isolation from the proper interpretation of specific provisions of the Act.<sup>3</sup>

In enacting the general anti-avoidance rule (GAAR) in section 245 of the Income Tax Act,<sup>4</sup> Parliament recognized, and accepted as a legitimate part of Canadian tax law, the well-known *Duke of Westminster*<sup>5</sup> principle—the taxpayer’s right to arrange his affairs so as to attract the least amount of tax; that is, to engage in tax planning.<sup>6</sup> But Parliament drew a distinction between legitimate tax minimization and abusive tax avoidance. The GAAR was intended to prevent tax planning undertaken solely for the purpose of exploiting tax law. To the extent that the GAAR applies, “the Duke of Westminster principle and the emphasis on textual interpretation may be attenuated.”<sup>7</sup> Ultimately, the GAAR “is intended to strike a balance between taxpayers’ need for certainty in planning their affairs and the government’s responsibility to protect the tax base and the fairness of the tax system.”<sup>8</sup>

In *The Queen v. Canada Trustco Mortgage Co.*<sup>9</sup> and *Mathew v. The Queen*,<sup>10</sup> the Supreme Court of Canada ruled for the first time on the application of the GAAR. The court was unanimous in holding that the GAAR applied in *Mathew* but not in *Canada Trustco*. The court articulated a textual, contextual, and purposive approach to statutory interpretation, which should put an end to the traditional textual or

1 Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Department of Finance, 1988), clause 186.

2 *The Queen v. Canada Trustco Mortgage Co.*, 2005 SCC 54, at paragraph 16.

3 *Ibid.*, at paragraph 76.

4 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

5 *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1 (HL).

6 *Canada Trustco*, supra note 2, at paragraph 31, quoting the explanatory notes, supra note 1, at clause 186.

7 *Canada Trustco*, supra note 2, at paragraph 13.

8 Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: Department of Finance, June 18, 1987), 130.

9 Supra note 2.

10 2005 SCC 55.

plain meaning approach, at least in the GAAR context.<sup>11</sup> The court also set forth a number of principles for the application of the GAAR, focusing particularly on subsection 245(4). The key issue in these two cases was whether an avoidance transaction constitutes abusive avoidance within the meaning of subsection 245(4).

In interpreting subsection 245(4), the court consolidated the “misuse” and “abuse” tests into a single “abuse” test. The court stated that a two-part inquiry is required in order to establish whether an abuse has occurred. The first part of the inquiry is to interpret the provisions giving rise to the tax benefit in order to determine their object, spirit, and purpose (collectively referred to as “legislative purpose”). This statutory interpretation issue is a question of law, guided by the textual, contextual, and purposive interpretation principle. Once the meaning and legislative purpose of the statutory provisions are determined, the second part of the inquiry is to determine whether the avoidance transaction falls within or frustrates that purpose. This stage involves applying the provisions to the facts of the case, and is described by the court as “necessarily fact-intensive.”<sup>12</sup>

On the question of economic substance, referred to in the Department of Finance explanatory notes on the GAAR (quoted above),<sup>13</sup> the Supreme Court confirmed that it may be relevant at various stages of the GAAR analysis. However, the court made it clear that economic substance cannot be isolated from the factual context of the case but “must be considered in relation to the proper interpretation of the specific provisions that are relied upon for the tax benefit.”<sup>14</sup>

Unfortunately, the court did not provide clear guidelines for drawing the line between legitimate tax planning and abusive tax avoidance. Although it acknowledged the possible relevance of economic substance, the court did not address the following key questions:

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11 In non-tax cases, the Supreme Court has adopted the textual, contextual, and purposive interpretation as a normative statutory interpretation principle (see, for example, *Montreal (City) v. 2952-1366 Québec Inc.*, 2005 SCC 62, heard at about the time of *Canada Trustco*). In tax cases, however, the court seemed to regard this interpretation approach as an “extraordinary” guide that is not generally applicable in the first instance. It is beyond the scope of this article to explore the philosophy and psychology that may underlie this distinction. For interesting commentary, see Neil Brooks, “The Responsibility of Judges in Interpreting Tax Legislation,” in Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications, 1997), 93-129, at 95-96; and Daniel M. Schneider, “Using the Social Background Model To Explain Who Wins Federal Appellate Tax Decisions: Do Less Traditional Judges Favor the Taxpayer?” (2005) vol. 25, no. 1 *Virginia Tax Review* 201-49.

12 *Canada Trustco*, supra note 2, at paragraph 44. The court reiterated (at paragraph 46) that, where the two-part inquiry is applied, the determination of abusive tax avoidance “is a question of fact” and then went on to state, “Provided the Tax Court judge has proceeded on a proper construction of the provisions of the Act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.”

13 Supra note 1.

14 *Canada Trustco*, supra note 2, at paragraph 76. See also paragraphs 56-60.

1. Why should economic substance be relevant in GAAR cases?
2. What does “economic substance” mean?
3. What are the relevant factors in determining the economic substance of transactions?
4. How can an economic substance analysis be applied in GAAR cases?

Meanwhile, the court evidently does not expect to be asked to hear another GAAR case in the near future. Lower courts now have the green light to look at the economic substance of transactions, but they are left without a roadmap for the search. In the first post-*Canada Trustco* case, *Evans v. The Queen*,<sup>15</sup> Bowman CJ cited economic substance as one of the factors in his subsection 245(4) analysis, but struggled with the meaning of this expression and failed to apply it appropriately.

This article aims at advancing our understanding of economic substance first by considering the relevance of the concept in the *Canada Trustco* and *Mathew* decisions and then by discussing each of the four questions identified above. The discussion is divided into five parts, summarized as follows:

- The first part briefly reviews the Supreme Court’s decisions in *Canada Trustco* and *Mathew*.
- The second part discusses why the concept of economic substance is relevant in GAAR cases. I argue that (1) the consideration of economic substance is called for by Parliament through the enactment of the GAAR; (2) it is consistent with the purposive approach to statutory interpretation; (3) it is justified on theoretical grounds; and (4) it is the best method for balancing conflicting policy concerns in Canadian income tax law. Since the Department of Finance stated specifically that “[s]ubsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance,”<sup>16</sup> it is logical to expect that this concept would play a crucial role in the GAAR analysis.
- The third part examines the meaning of “economic substance.” I maintain that this concept involves more than “legal substance” and requires one to look at the economic result or the economic reality of a transaction. It clarifies whether any economic value or profit (other than tax savings) is expected to be earned from a transaction, or whether the taxpayer’s financial position is to be altered in a meaningful way, as a result of the transaction as stipulated in the legal documentation.
- The fourth part discusses the factors that are relevant in determining the economic substance of transactions—specifically, expected non-tax profit, exposure to risk and market forces, and the involvement of tax-indifferent parties or intermediaries.

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15 2005 TCC 684.

16 *Supra* note 1, quoted in *Canada Trustco*, *supra* note 2, at paragraphs 48-49.

- The fifth part examines the application of an economic substance analysis in GAAR cases. I suggest that Canadian courts should embrace economic substance as a useful analytical tool in applying the GAAR. Even though “economic reality” is not in favour in recent jurisprudence, the courts have been called upon to examine *all* of the relevant facts and circumstances of a case in certain areas of the law, such as determining what is “reasonable” and what is a “fair market value.” I refer to both Canadian and foreign jurisprudence to shed light on the economic analysis of tax-avoidance transactions.

## CANADA TRUSTCO AND MATHEW: ECONOMIC SUBSTANCE MAY BE RELEVANT

### Canada Trustco

*Canada Trustco* involved a factually complex but conceptually straightforward type of leveraged lease. The Supreme Court summarized the facts as follows:

Briefly stated, on December 17, 1996, the respondent, with the use of its own money and a loan of approximately \$100 million from the Royal Bank of Canada (“RBC”), purchased trailers from Transamerica Leasing Inc. (“TLI”) at fair market value of \$120 million. CTMC [Canada Trustco] leased the trailers to Maple Assets Investments Limited (“MAIL”) who in turn subleased them to TLL, the original owner. TLI then prepaid all amounts due to MAIL under the sublease. MAIL placed on deposit an amount equal to the loan for purposes of making the lease payments and a bond was pledged as security to guarantee a purchase option payment to CTMC at the end of the lease. These transactions allowed CTMC to substantially minimize its financial risk. They were also accompanied by financial arrangements with various other parties, not relevant to this appeal.<sup>17</sup>

For Canadian tax purposes, Canada Trustco treated the stated cost of the trailers as their capital cost and deducted capital cost allowance (CCA) in computing its profit. From the taxpayer’s perspective, “[t]he transaction provides very attractive returns by generating CCA deductions which can be used to shelter other taxable lease income generated by Canada Trust.”<sup>18</sup> The minister invoked the GAAR in denying the CCA deductions.<sup>19</sup>

At the Supreme Court, the Crown argued<sup>20</sup> that (1) the object and spirit of the CCA provisions is “to provide for the recognition of money spent to acquire

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17 *Canada Trustco*, supra note 2, at paragraph 3.

18 *Ibid.*, at paragraph 2.

19 The taxpayer’s appeal to the Tax Court of Canada was upheld (2003 DTC 587; [2003] 4 CTC 2009). The Tax Court’s decision was affirmed by the Federal Court of Appeal (2004 DTC 6119; [2004] 2 CTC 276). The minister of national revenue sought leave to appeal to the Supreme Court of Canada, which was granted.

20 *Canada Trustco*, supra note 2, at paragraph 70.

qualifying assets to the extent that they are consumed in the income-earning process”; and (2) the circular sales-leaseback transaction involved “no real risk” and the taxpayer did not actually spend \$120 million to purchase the trailers. Because the taxpayer created a “cost for CCA purposes that is an illusion” without incurring any “real” expense, the arrangement contravened the object and purpose of the CCA provisions and constituted abusive tax avoidance. The Crown’s economic substance argument was framed as follows:

In this case, the pre-ordained series of transactions misuses and abuses the CCA regime because it manufactures a cost for CCA purposes that does not represent the real economic cost to CTMC of the trailers. . . . *There was no risk at all that the rent payments would not be made.* Even the \$5.9 million that CTMC apparently paid in fees was fully covered as it, along with the rest of CTMC’s contribution of \$24.9 million in funding, will be reimbursed when the \$19 million bond pledged to CTMC matures in December 2005 at \$33.5 million.<sup>21</sup>

In contrast, as the Supreme Court noted, Canada Trustco relied on the Tax Court’s conclusion that “the transaction was a profitable commercial investment and fully consistent with the object and spirit of the Act.”<sup>22</sup> Canada Trustco argued that the policy of the Act is that “cost” means the price (the amount) that the taxpayer gave up in order to get the asset (except in specific circumstances not applicable to the case at issue), and that “[a] cost is not reduced to reflect a mitigation of economic risk.”<sup>23</sup> Thus, the transaction was not abusive. Canada Trustco’s position prevailed.

The Supreme Court found that the purpose of the CCA provisions, as applied to sale-leaseback transactions, was to permit deduction of CCA based on the cost of the assets acquired. “This purpose emerges clearly from the scheme of the CCA provisions within the Act as a whole.”<sup>24</sup> The provisions of the Act do not refer to “economic risk” but only to “cost.”<sup>25</sup> Moreover, the court found the Crown’s submission on “economic substance” to be “narrow”:

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21 Ibid. (emphasis added by the court).

22 Ibid., at paragraph 71. This is a factual determination. The Tax Court considered whether, as an evidentiary matter, the taxpayer had behaved in a fashion that reflected reliance on the legal formulation and concluded that transactions of this nature are normal commercial transactions. Since the Supreme Court regarded this as a question of fact, it simply adopted the Tax Court’s characterization.

23 Ibid., at paragraphs 71 and 72.

24 Ibid., at paragraph 74.

25 The specified leasing property rules implicitly reflect decisions about the economic implications of certain sale-leaseback transactions. In the context of CCA, cost is a well-understood legal concept. The court stated, *ibid.*, at paragraph 75, “Like the Tax Court Judge, we see nothing in the GAAR or the object of the CCA provisions that permits us to rewrite them to interpret ‘cost’ to mean ‘amount economically at risk’ in the applicable provisions.”



It did not focus on the purpose of the CCA provisions read in the context of the Act as a whole, to determine whether the tax benefit fell outside the object, spirit or purpose of the relevant provisions.<sup>26</sup>

Overall, the Supreme Court's analysis of subsection 245(4) in the context of this case is disappointing. A "textual, contextual and purposive" interpretation of the concept of "cost" was effectively reduced to a mere "textual" interpretation. The court did not fully examine the broader statutory context of the concept of "cost." Nor did the court shed much light on how to establish the legislative purpose of the CCA provisions; it simply declared that the purpose "emerges clearly from the scheme of the CCA provisions within the Act as a whole." To back up its conclusion that "cost" refers only to "legal" cost, and not to "economic" cost, the court drew a negative inference from the fact that Parliament introduced economic risk into the meaning of cost in subsections 13(7.1) and (7.2) of the Act (which adjust the cost of depreciable property when a taxpayer receives government assistance), but not in the context of CCA provisions.

With respect to the "factual context" of this case, the court adopted the "legal substance" analysis of the transactions:

Here the documents detailing the transaction left no uncertainty as to the relationships between the parties. CTMC paid \$120 million to TLI for the equipment, partly with borrowed funds and partly with its own money. Having become the owner of the equipment, it leased it to MAIL. MAIL then subleased it back to the vendor, TLI. The relationships between the parties as expressed in the relevant documentation were not superfluous elements; they were the very essence of the transaction.<sup>27</sup>

The Supreme Court upheld the Tax Court's characterization of the transaction as being "not so dissimilar from an ordinary sale-leaseback [as] to take it outside the object, spirit or purpose of the relevant CCA provisions."<sup>28</sup> As noted above, the Supreme Court also relied on the Tax Court's conclusion that "the transaction was a profitable commercial investment and fully consistent with the object and spirit of the Act." The Supreme Court did not mention the fact that the transaction was "profitable" only because of the tax savings (CCA deductions and interest expense deduction). If profit means pre-tax profit, the transaction was not profitable; it was designed to generate a "loss" in order to shelter the taxpayer's profit from other transactions.

## Mathew

The *Mathew* case involved a transfer of business losses from a corporation to unrelated persons through the use of a partnership. Standard Trust Company was in the

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26 Ibid., at paragraph 76.

27 Ibid., at paragraph 77.

28 Ibid., at paragraph 78.

business of lending money on the security of mortgages of real property. As a result of financial difficulties, Standard Trust was wound up in 1991. Standard Trust’s assets included a portfolio of mortgage loans (“the STIL II portfolio”) with a total cost of \$85 million and a fair market value of \$33 million, and thus accrued losses of \$52 million. These losses were of no value to Standard Trust because of its insolvency. In order to maximize the amount realized by Standard Trust on liquidation, the liquidator devised a plan to sell the portfolio. The following steps were taken:

1. Standard Trust incorporated a wholly owned subsidiary.
2. Standard Trust entered into a partnership with the subsidiary (“partnership A”). The interests of Standard Trust and its subsidiary in partnership A were 99 percent and 1 percent respectively.
3. The STIL II portfolio was transferred to partnership A at a cost of \$85 million pursuant to subsection 18(13) of the Act.<sup>29</sup>
4. The liquidator carried out an intensive campaign to market Standard Trust’s 99 percent interest in partnership A and, after difficult and protracted negotiations, eventually sold it to OSFC Holdings Ltd.
5. OSFC assigned its partnership interest to a general partnership (“partnership B”).
6. OSFC retained an interest in partnership B but sold interests in the partnership to a number of individuals and entities (the taxpayers in the *Mathew* case). On the eventual sale or writedown of the STIL II portfolio, partnership B allocated the portfolio losses to its partners, including the taxpayers, who claimed their proportionate shares of the losses as a deduction against their own incomes.

As a result of these transactions, Standard Trust’s accrued losses of \$52 million were transferred to various arm’s-length taxpayers through the use of subsection 18(13) and the partnership vehicle.<sup>30</sup>

A textual, contextual, and purposive interpretation of subsection 18(13) and the partnership rules in section 96 led the Supreme Court to conclude that the purpose of these provisions is “to prevent a taxpayer who is in the business of lending money from claiming a loss upon the superficial disposition of a mortgage or similar non-capital property”<sup>31</sup>—not to facilitate the transfer of losses to arm’s-length persons.

29 By virtue of subsection 18(13) of the Act, the \$52 million in accrued losses was disallowed on the transfer of the portfolio to the partnership; instead, the amount of the losses was added to the fair market value of the portfolio, resulting in a cost to the partnership of \$85 million.

30 The taxpayers in *Mathew* had a tough case even before they reached the Supreme Court. In *OSFC Holdings Ltd. v. The Queen*, 2001 DTC 5471; [2001] 4 CTC 82, the Federal Court of Appeal ruled against the taxpayer and held that the transactions constituted an abuse of the provisions of the Act read as a whole. In *Mathew*, not surprisingly, the taxpayers lost at both the Tax Court (2002 DTC 1637; [2003] 1 CTC 2045) and the Federal Court of Appeal (2003 DTC 5644; [2004] 1 CTC 115).

31 *Mathew*, supra note 10, at paragraph 53.

Allowing the appellants to deduct the losses would frustrate this purpose. In other words, the transaction was not of the type contemplated by Parliament:

A purposive interpretation of the interplay between s. 18(13) and s. 96(1) indicates that they allow the preservation and sharing of losses on the basis of shared control of the assets in a common business activity.<sup>32</sup>

The lack of such common business activity presumably renders the transaction abusive.

In reaching its decision, the court found the following facts relevant:<sup>33</sup>

1. The losses originated from the failure of Standard Trust.
2. Partnership A served as a “holding vehicle” for the unrealized losses that Standard Trust planned from the outset to sell to arm’s-length parties.
3. Partnership B was relatively passive; its purpose was simply to realize and allocate the tax losses without any other significant activity.
4. Even though the partners of partnership B paid substantial amounts to acquire their partnership interests and sought to minimize their exposure to risk, these facts cannot negate the above conclusions.
5. Neither partnership A nor partnership B ever dealt with real property, apart from the original mortgage portfolio from Standard Trust.
6. Standard Trust was never in a partnership relationship with either OSFC or any of the taxpayers.
7. The purported non-arm’s-length relationship between partnership A and Standard Trust was vacuous and artificial.

### Shifting Judicial Attitude Toward Economic Analysis?

Prior to the *Canada Trustco* and *Mathew* decisions, the Supreme Court did not generally permit the characterization of a transaction on the basis of its economic realities.<sup>34</sup> Instead, it generally embraced the legal substance doctrine. The legal substance doctrine was a natural fit with the traditional textual interpretation, under which both the statute and the taxpayer’s transaction are given a literal construct. What is puzzling is that after adopting the “modern rule” of statutory interpretation in *Stuart Investments*<sup>35</sup> (that the provisions of the Act are to be interpreted in harmony with the object and purpose of the Act), the court remained wedded to a

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32 Ibid., at paragraph 62.

33 Ibid., at paragraphs 61 and 62.

34 It was argued that the economic substance concept was not part of Canadian tax law. See Brian J. Arnold, “Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance,” in Harry Erlichman, ed., *Tax Avoidance in Canada: The General Anti-Avoidance Rule* (Toronto: Irwin Law, 2002), 41-81, at 67.

35 *Stuart Investments Limited v. The Queen*, 84 DTC 6305; [1984] CTC 294 (SCC).

formalistic construction of taxpayers’ transactions. Although the court noted, in *Shell Canada*, that it had “repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form,”<sup>36</sup> the following caveat effectively “eviscerated” the economic substance concept:<sup>37</sup>

[T]his Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer’s *bona fide* relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer’s legal relationships must be respected in tax cases.<sup>38</sup>

Thus, contrary to what Dickson CJ had anticipated in *Bronfman Trust*, there was no trend in Canadian tax cases “towards attempting to ascertain the true commercial and practical nature of the taxpayer’s transactions.”<sup>39</sup> For that reason, the Supreme Court’s new stance on economic substance in *Canada Trustco* could be viewed as a shift in judicial thinking. The Supreme Court did not dismiss the relevance of the economic substance concept, and in the following statement in *Mathew*, the court seemed to contemplate the possibility that a transaction with legal substance may nevertheless be found to be abusive under subsection 245(4):

[A]busive 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.<sup>40</sup>

However, it would be wrong to suggest that the shift in thinking is a fundamental one, because the court appears to have limited the economic substance analysis to the GAAR context. In that sense, little has changed since *Shell*.<sup>41</sup> Nevertheless, it is clear that the economic substance of transactions is potentially relevant in GAAR cases.

### Remaining Questions on Economic Substance

There are many questions that remain unanswered after *Canada Trustco* and *Mathew*. The Supreme Court considered the *Duke of Westminster* principle and the GAAR to

36 *Shell Canada Limited v. The Queen et al.*, 99 DTC 5669; [1999] 4 CTC 313, at paragraph 39 (SCC).

37 Arnold, *supra* note 34, at 64.

38 *Shell Canada*, *supra* note 36, at paragraph 39.

39 *The Queen v. Bronfman Trust*, 87 DTC 5059, at 5067; [1987] 1 CTC 117, at 128 (SCC).

40 *Mathew*, *supra* note 10, at paragraph 31.

41 It is beyond the scope of this article to debate why the economic substance concept should be relevant to the interpretation of provisions of the Act other than section 245. As a general proposition, characterization of transactions based on what has actually happened is consistent with the textual, contextual, and purposive interpretation of statutory provisions.

coexist in Canadian law. Why, then, did that principle save a loss-generating scheme in *Canada Trustco* but not a loss-shifting scheme in *Mathew*? Why did the court go beyond the statutory language in searching for the object, spirit, and policy in *Mathew* but not in *Canada Trustco*? Could it be that the transaction in *Canada Trustco* is similar to an “ordinary business transaction” and the one in *Mathew* is not? If so, what are the key features of an ordinary business transaction? Are ordinary business transactions presumed to be transactions “with real economic substance” and thus free from the GAAR? If so, why not start with an economic substance analysis in the first place?<sup>42</sup> For that matter, what is meant by “economic substance”?

The following statement suggests that the court itself was not entirely clear as to what an “economic substance” analysis would entail:

A transaction may be considered to be “artificial” or to “lack substance” *with respect to specific provisions of the Income Tax Act*, if allowing a tax benefit would not be consistent with the object, spirit or purpose of those provisions. We should reject any analysis under s. 245(4) that depends entirely on “substance” viewed in isolation from the proper interpretation of specific provisions of the *Income Tax Act* or the relevant factual context of a case.<sup>43</sup>

With respect, there are several problems with this statement. First, a transaction may be considered to be “artificial” or to “lack substance” on the basis of a legal and economic analysis, not “with respect to specific provisions of the *Income Tax Act*.” Since the question of substance is a factual determination, the court must attempt to establish “what actually happened.” The tax consequences of transactions without substance are governed by the provisions of the Act. Second, the statement above is problematic in light of the language in subsection 245(4), which was recently amended to remove the “double negative,”<sup>44</sup> and which requires the abuse analysis to be performed with reference to the provisions of the Act read as a whole, not just the “specific provisions.” Third, surely the court must reject any analysis under subsection 245(4) that depends entirely on “substance” if the provisions of the Act do not require a transaction to have economic substance. Finally, the court’s suggestion that a “substance” analysis could be conducted “in isolation from . . . the relevant factual context of a case” is simply puzzling.

The unsettled state of the law on where to draw the line between legitimate tax planning and abusive tax avoidance makes it important to appreciate the relevance of the economic substance analysis. The discussion that follows addresses the four key questions identified in the introduction to this article.

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42 In *Evans*, supra note 15, Bowman CJ listed the existence of real economic substance among the key factors to be considered in determining whether a transaction is abusive. The *Evans* decision is discussed later in this article (see the text at note 78 and following).

43 *Canada Trustco*, supra note 2, at paragraph 60.

44 Subsection 245(4) formerly stated that the GAAR “does not apply to a transaction where it may reasonably be considered that the transaction would not result” in a misuse or an abuse; the amended provision states that the GAAR applies “only if it may reasonably be considered. . . .”

## WHY SHOULD ECONOMIC SUBSTANCE BE IMPORTANT UNDER THE GAAR?

In this part of the article, I argue that the notion of economic substance is important to the GAAR analysis for four reasons. First, an economic analysis of avoidance transactions is called for by section 245. Second, it is consistent with the textual, contextual, and purposive approach to statutory interpretation. Third, it is justifiable under the “self-defeating” rationale. Fourth, it provides a means of maintaining an appropriate balance between conflicting policy concerns underlying the Canadian tax system.

### Statutory Requirement Under Section 245

A textual, contextual, and purposive interpretation of section 245 leads to one conclusion: this provision calls for the consideration of economic substance of an avoidance transaction. The text of subsection 245(4) provides that an avoidance transaction is subject to the GAAR

only if it may reasonably be considered that the transaction . . . would . . . result directly or indirectly in a misuse of the provisions of [the Act or another relevant taxing statute] . . . or . . . in an abuse having regard to those provisions, other than this section, read as a whole.

Two notable aspects of this text confirm the relevance of the economic substance doctrine. The first is the reasonableness requirement. The reasonableness inquiry in Canadian tax law has always been based on an examination of the facts and circumstances of the case, from the perspective of a reasonable third position. For example, in determining whether an amount of expense was reasonable under section 67 of the Act, the court applied the standard of whether a reasonable businessman, having in mind exactly the same business considerations as the appellant, would have contracted to pay such an amount.<sup>45</sup> The second notable aspect of subsection 245(4) is the emphasis on the result of the transaction. This “suggests that all the consequences of the transactions—legal, financial, commercial, and economic—should be considered.”<sup>46</sup>

The text of subsection 245(5) also clearly requires an economic substance analysis of the avoidance transaction in order to assess the appropriate tax consequences. More specifically, subsection 245(5) provides that

45 *Gabco Ltd. v. MNR*, 68 DTC 5210; [1968] CTC 313 (Ex. Ct.); *Goldbar Estate v. MNR*, 88 DTC 1149; [1988] 1 CTC 2187; *Maduke Foods Ltd. v. The Queen*, 89 DTC 5458; [1989] 2 CTC 284 (FCTD); and *Petro-Canada v. The Queen*, 2004 DTC 6329; [2004] 3 CTC 156 (FCA).

46 Brian J. Arnold, “The Long, Slow, Steady Demise of the General Anti-Avoidance Rule” (2004) vol. 52, no. 2 *Canadian Tax Journal* 488-511, at 507.

(c) the nature of any payment or other amount may be *recharacterized*, and  
(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,  
in *determining the tax consequences to a person as is reasonable in the circumstances* in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction [emphasis added].

The historical context of the enactment of section 245 “confirms that economic realities must be relevant under subsection 245(4) if the GAAR is to be effective in preventing abusive tax avoidance.”<sup>47</sup> Parliament enacted the GAAR in reaction to the Supreme Court’s decision in *Stubart*, which rejected the business purpose test and refused to examine the economic realities of the taxpayer’s transaction.<sup>48</sup> By overruling the *Stubart* decision, which had, in turn, rejected the economic reality and business purpose test that originated in *Gregory v. Helvering*,<sup>49</sup> Parliament explicitly endorsed a bona fide non-tax purpose test under subsection 245(3). Presumably, the economic substance doctrine, also derived from *Gregory v. Helvering*, was implicitly incorporated into subsection 245(4).

The statutory context of section 245 also makes it important to consider economic substance under the abuse analysis pursuant to subsection 245(4). The GAAR was intended to be a provision of last resort and would apply only to transactions that otherwise complied with all of the other relevant provisions of the Act. Since the economic substance of a transaction is generally irrelevant in applying the provisions of the Act other than section 245, the transactions giving rise to the tax benefit must be characterized in accordance with their legal form and substance. In addition, recharacterizing transactions on the basis of economic realities is generally prohibited under subsection 245(3) in determining whether a transaction is an avoidance transaction. “Accordingly, it is difficult to see how transactions could be considered to be abusive if the economic substance of what the taxpayer did cannot be considered.”<sup>50</sup>

Finally, as the Supreme Court correctly stated in *Canada Trustco*, “[t]he GAAR’s purpose is to deny the tax benefits of certain arrangements that comply with a literal interpretation of the provisions of the Act, but amount to an abuse of the provisions of the Act.”<sup>51</sup> A transaction lacking economic substance is typically arranged for

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47 Ibid.

48 The Supreme Court stated in *Canada Trustco*, supra note 2, at paragraph 14, “[T]he Court [in *Stubart*] also rejected the business purpose test, which would have restricted tax reduction to transactions with a real business purpose. Instead of the business purpose test, the Court proposed guidelines to limit unacceptable tax avoidance arrangements. Parliament deemed the decision in *Stubart* an inadequate response to the problem and enacted the GAAR.”

49 293 US 465 (1935); aff’g. *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934) (per Hand J). This case is discussed below (see the text at note 53 and following).

50 Arnold, supra note 46, at 507.

51 *Canada Trustco*, supra note 2, at paragraph 16.

the sole purpose of gaining a tax benefit and does not effect any meaningful change in the economic position of the taxpayer other than the tax savings. Therefore, an economic analysis of an avoidance transaction helps determine whether the transaction falls within the GAAR.

### Purposive Statutory Interpretation

Whether a transaction should be characterized according to its legal form or its economic substance is obviously a different question from whether the Act should be given a textual or purposive interpretation. But the two questions are intimately related. Under a regime of textual interpretation, the courts are less likely to read the Act as authorizing an inquiry that goes beyond legal substance. Under a purposive interpretation, the argument that the Act imposes liability on an economic result (as opposed to a legal form) becomes more appealing. The economic substance analysis has a more natural fit with a purposive interpretation of the statute.

Under the Supreme Court’s “textual, contextual and purposive” approach to statutory interpretation, the textual meaning of a provision of the Act must be consistent with the context and purpose of the provision. Since (according to the explanatory notes on the GAAR) “the provisions of the Act are generally intended to apply to transactions with real economic substance,” transactions lacking real economic substance would *prima facie* frustrate the legislative purpose. The only exception is the case where it can reasonably be concluded that such a transaction is intended to fall outside the GAAR.<sup>52</sup>

According to judicial experience in the United States, the economic analysis of transactions is important to a purposive interpretation of taxing statutes. The origin of the so-called economic substance doctrine (which serves as a judicial anti-avoidance rule in the United States) is generally traced to *Gregory v. Helvering*.<sup>53</sup> In that case, Mrs. Gregory owned all the stock of United Mortgage Corporation (“United”), which held among its assets 1,000 shares of stock of the Monitor Securities Corporation (“Monitor”). Mrs. Gregory wanted to liquidate the Monitor shares; however, the proceeds from the sale would be subjected to two levels of taxation if she simply directed United to sell the Monitor stock and then distribute the proceeds to her. Consequently, Mrs. Gregory undertook the following sequence of transactions: (1) a new company was formed; (2) three days later, the Monitor

52 David G. Duff, “The Supreme Court of Canada and the General Anti-Avoidance Rule: Canada Trustco and Mathew” (2006) vol. 60, no. 2 *Bulletin for International Fiscal Documentation* 54-71.

53 This case is often cited as the source for “first principles” on the economic substance doctrine and the business purpose test. See Joseph Isenbergh, “Musings on Form and Substance in Taxation” (1982) vol. 49, no. 3 *University of Chicago Law Review* 859-84, at 866; David P. Hariton, “Sorting Out the Tangle of Economic Substance” (1999) vol. 52, no. 2 *The Tax Lawyer* 235-73; Louis Kaplow, “Rules Versus Standards: An Economic Analysis” (1992) vol. 42, no. 3 *Duke Law Journal* 557-629, at 573; and Stewart Patton, “Treasury Regulation § 301.6111-2T and the Economic Substance Doctrine: A Plea for Certainty in the Tax Law” (2002) vol. 39, no. 2 *Houston Law Review* 499-528, at 509.



shares were transferred to the new company; (3) the new company was dissolved within the same week; and (4) the Monitor shares were transferred to Mrs. Gregory as part of the dissolution, so that she realized a capital gain. Ostensibly, these transactions met the requirements of a “reorganization” under the Revenue Act of 1928. As such, the transfer of Monitor stock to the new company would be tax-free, and the subsequent liquidation of the new company would give rise to a capital gain in the hands of the shareholder who had received the distribution of shares. The result of the transfer, however, was the same as a simple dividend distribution, and the commissioner sought to tax it as such. Should the transaction be characterized according to the form or the economic result?

Learned Hand, writing for a panel of judges of great intellectual prestige,<sup>54</sup> held that the transaction conformed to the literal language of the statute, and if it fell within the language of the statute, it did not matter that the sole purpose was to avoid tax. However, he opined that the concept of “reorganization” involves doing something for a business purpose and not solely to avoid tax. He stated:

[I]f what was done here was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of income tax, as it certainly was. Nevertheless, it does not follow that Congress meant to cover such a transaction. . . . [T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. The purpose of the section is plain enough; men engaged in enterprises . . . might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as “realizing” any profit, because the collective interests still remained in solution. But the underlying presupposition 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*. To dodge the shareholders’ taxes is not one of the transactions contemplated as corporate “reorganizations.” . . .

[W]e cannot treat as inoperative the transfer of the . . . shares. . . . [T]he transfer passed title . . . and the taxpayer became a shareholder in the transferee. All these steps were real, and their only defect was that they were not what the statute means by a “reorganization.”<sup>55</sup>

Learned Hand’s reasoning “has left echoes in every corner of the tax law”<sup>56</sup> in the United States and beyond. The italicized words in the quotation above mark the birth of the economic substance doctrine.<sup>57</sup> Mrs. Gregory was denied the benefit of the objective tax result because the transaction did not change her economic position, apart from the tax benefit, nor did it reflect any facet of the business of United.

54 Isenbergh, *supra* note 53, at 867. See also Marvin A. Chirelstein, “Learned Hand’s Contribution to the Law of Tax Avoidance” (1968) vol. 77, no. 3 *Yale Law Journal* 440-74.

55 *Helvering v. Gregory*, *supra* note 49, at 810-11 (2d Cir.) (emphasis added).

56 Isenbergh, *supra* note 53, at 867.

57 *Ibid.*

In other words, the transaction lacked economic substance, and it was not “the thing which the statute intended.”<sup>58</sup>

### Theoretical Rationale

According to the so-called self-defeating theory of statutory interpretation, the courts should not presume that Parliament intended to allow taxpayers to defeat its intention through contrived, artificial transactions.<sup>59</sup> In other words, this theory holds that it is not reasonable to interpret the applicable tax law to be self-defeating.

The self-defeating rationale requires an economic analysis of transactions. Hand J explained this rationale in the US context as follows:

The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.<sup>60</sup>

This statement echoes the reasoning behind Canada’s GAAR, which is intended to reconcile the same tensions. The self-defeating rationale is clearly expressed in the explanatory notes and recognized by the Supreme Court. In finding that the GAAR applied in *Mathew*, the court stated that the “only reasonable conclusion is that the series of transactions frustrated Parliament’s purpose of confining the transfer of losses such as these to a non-arm’s length partnership.”<sup>61</sup>

### Balancing Competing Policy Concerns

There appear to be two major sets of competing policy concerns in Canadian tax law: the taxpayer’s right to engage in tax planning versus the government’s right to prevent abusive tax avoidance; and the taxpayer’s need for certainty, predictability, and fairness versus the government’s need to protect the tax base and preserve the fairness of the tax system as a whole. Economic substance provides a useful standard for determining whether a particular transaction reflects a balance between these competing concerns.

### *Legitimate Tax Minimization Versus Abusive Tax Avoidance*

As mentioned earlier, the GAAR was intended to draw a line between legitimate tax minimization and abusive tax avoidance. The question of “legitimacy” is presumably

58 *Gregory v. Helvering*, supra note 49, at 468 (SC).

59 Robert Thornton Smith, “Business Purpose: The Assault upon the Citadel” (1999) vol. 53, no. 1 *The Tax Lawyer* 1-34, at 4-6.

60 *Gilbert v. Commissioner of Internal Revenue*, 248 F. 2d 399, at 411 (2d Cir. 1957) (Hand J, dissenting).

61 *Mathew*, supra note 10, at paragraph 62.

decided on the basis of the expectations, intention, or mind of Parliament as expressed in the Act; it is not about some notion of “tax morality.”<sup>62</sup> For example, if Parliament intended a tax benefit to be enjoyed in certain situations, a transaction that takes advantage of the tax benefit is legitimate. On the other hand, if a tax benefit is obtained in a situation that Parliament did not contemplate, or could not reasonably be expected to have contemplated, the transaction resulting in the tax benefit should be considered illegitimate.

How can tax law reconcile the conflicting tensions between legitimate and illegitimate tax planning? One suggestion is to require that a transaction, to be respected, must have economic substance or must genuinely involve mixed business and tax motives. Incorporating an economic analysis of avoidance transactions under the GAAR does not mean that the government or the courts are allowed to intrude upon transactions involving mixed business and tax motives or consequences. The GAAR only seeks to challenge transactions for which the sole justification was the avoidance of taxes. The Supreme Court recognized in *Canada Trustco* that the GAAR “attenuates” the right of the taxpayers to engage in tax planning.<sup>63</sup> The degree of attenuation is best determined by reference to the economic substance of the transaction at issue.

### ***“Certainty, Predictability and Fairness” for the Taxpayer Versus Protection of the Tax Base and Fairness of the System***

As the Supreme Court noted in *Canada Trustco*, the preservation of “certainty, predictability and fairness” for individual taxpayers is considered a “basic tenet of tax law.”<sup>64</sup> On the other hand, the GAAR requires the balancing of this set of policy concerns against the concern for protection of the tax base and the fairness of the tax system as a whole.

The importance of “certainty and predictability” is often asserted; however, there has been little analysis of how uncertainty affects taxpayer behaviour or welfare. Presumably, certainty is necessary in a self-assessment system—people need to be able to fill out their tax returns. It is important that the “millions of individuals” who engage in “billions of transactions” be able to file annual tax returns with some degree of certainty without incurring substantial compliance costs.<sup>65</sup> In fact, however, the GAAR cases generally involve situations that do not concern the majority of taxpayers, and the transactions are well planned and executed on the basis of professional tax advice. Therefore, the requirement of certainty does not ring true in GAAR cases. More likely, perhaps, the plea for more certainty and predictability

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62 For a fuller discussion of the concept of legitimacy, see Ronald Dworkin, *Law's Empire* (Cambridge, MA: Belknap Press, 1986).

63 *Canada Trustco*, supra note 2, at paragraph 13.

64 *Ibid.*, at paragraph 61.

65 David A. Weisbach, “Ten Truths About Tax Shelters” (2002) vol. 55, no. 2 *Tax Law Review* 215-53, at 248.

is based on the presumption and the expectation that detailed tax provisions will provide significant certainty. It may also represent self-interest on the part of tax professionals to the extent that the ability to provide certain answers makes their services more valuable.<sup>66</sup> On the basis of the available research, however, the behavioural effect of uncertainty cannot be predicted:

We cannot tell whether the uncertainty has good or bad effects. And we cannot determine whether reducing the uncertainty is a good or bad idea. It can go either way. If this is the case, we should have no strong feelings against uncertainty—increasing uncertainty may hurt, but so may decreasing it.<sup>67</sup>

“Certainty” is also a relative concept. Absolute certainty is impossible because taxes are imposed on real business transactions, which cannot always be predicted by Parliament. In fact, the Act requires line drawing in respect of fundamental questions, such as whether an economic receipt is from a “source” or a “windfall” and whether it is on income or capital account. As discussed below, because the nature of economic analysis is flexible, there are naturally alternative formulations of the economic substance test and different conclusions may be drawn from similar facts. That does not mean, however, that the economic substance analysis is inherently “uncertain” or “unpredictable.” It would be unfortunate if Canadian courts refused to look at economic substance for the sake of promoting “certainty” and “predictability.”<sup>68</sup>

More importantly, certainty is not the only basic policy objective and should not be pursued at any cost. In attempting to provide certainty, the Act includes a great many rules governing specific types of transactions. Many specific rules create bright-lines; tax consequences depend entirely on which side of the line the transaction falls. These rules offer tax planners the opportunity to design transactions to minimize or avoid tax. (An example is the “butterfly” reorganization rules.) In enacting the GAAR, Parliament expressed its preference for “general principles” over “specific rules” in dealing with tax avoidance, in order to reduce—to quote the Supreme Court in *Stubar*—“[the] action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the

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66 Ibid.

67 Ibid., at 249. It is possible, though, that uncertainty affects taxpayers differently depending on their risk aversion: the aggressive, or risk seeking, may react to uncertainty by taking more aggressive tax positions, while the meek may be deterred.

68 With respect, the Supreme Court’s following statement in *Canada Trustco*, supra note 2, at paragraph 75, should be understood in the context of that case and should not be followed where the GAAR demands an economic analysis: “Like the Tax Court judge, we see nothing in the GAAR or the object of the CCA provisions that permits us to rewrite them to interpret ‘cost’ to mean ‘amount economically at risk’ in the applicable provisions. To do so would be to invite inconsistent results. The result would vary with the degree of risk in each case. This would offend the goal of the Act to provide sufficient certainty and predictability to permit taxpayers to intelligently order their affairs.”

inevitable, professionally-guided and equally specialized taxpayer reaction.”<sup>69</sup> It was contemplated that the uncertainty created by the GAAR should not be so great as to outweigh its expected benefits. The economic substance standard brings certainty and predictability to the GAAR analysis because it is an objective test based on the commercial reality of the business world. It ensures that ordinary business transactions are not affected by the GAAR. As in any other line-drawing exercise, however, an element of uncertainty is expected.

“Fairness” is a fundamental notion of tax policy. It certainly encompasses fair treatment of individual taxpayers. But more importantly, fairness refers to fair treatment of taxpayers as a whole. In introducing the new anti-avoidance provisions, the government made it clear that the GAAR “is an essential element in protecting the expanded tax base against further erosion and stabilizing income tax revenues” and that “equity requires that firm measures be taken to block sophisticated strategies designed to yield tax advantages that were not intended by Parliament.”<sup>70</sup> Dickson CJ remarked in *Bronfman Trust*:

Assessment of taxpayers’ transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon the taxpayer’s sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction.<sup>71</sup>

Much earlier, expressing a similar concern, the Carter report referred to

the sense of injustice and inequity which tax avoidance raises in the breasts of those unable or unwilling to profit by it. Opportunities of tax avoidance are not equal, for it clearly has little practical meaning to salaried and wage-earning taxpayers from whom tax is deducted at source. . . .

A taxpayer who uses devices and schemes to minimize the tax that he should pay reduces his tax burden unfairly and shifts the avoided tax to other taxpayers. There is little information available as to how much of the tax burden is shifted through tax avoidance devices.<sup>72</sup>

The fairness principle requires one to examine the objective aspects of a deal, whether simple or complex. This seems only fair. Most transactions are very sophisticated and complex. Through economic analysis, the courts have the means to examine transactions and opine on whether taxpayers have crossed the threshold separating

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69 *Stuart*, supra note 35, at 6324; 317.

70 Canada, Department of Finance, *Supplementary Information Relating to Tax Reform Measures* (Ottawa: Department of Finance, December 16, 1987), 99.

71 *Supra* note 39, at 5067; 128.

72 Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen’s Printer, 1967), appendix A, at 542.

intelligent tax planning from improper tax avoidance. The economic substance analysis also respects the fact that transactions with similar economic consequences are taxed similarly, thereby avoiding tax distortions.

## WHAT DOES “ECONOMIC SUBSTANCE” MEAN?

The Supreme Court mentioned in *Canada Trustco* that “the expression economic substance may be open to different interpretations.”<sup>73</sup> What are these interpretations? Does “economic substance” mean anything more than “legal substance”? If so, in what sense, and how is economic substance related to legal substance?

### “Legal Substance” Versus “Economic Substance”

The explanatory notes on the GAAR referred to “real economic substance,” presumably to emphasize that the inquiry is an economic one. The economic substance standard requires an examination of taxpayers’ transactions “from a similar perspective that Wall Street uses—economic analysis”<sup>74</sup> (or, as we would say in Canada, Bay Street). It should be made clear that “economic substance” refers to substance other than tax savings. It may be true that for some businesses, there is little, if any, meaningful difference between an improvement in financial performance achieved by cutting operating expense and one that results from reducing taxes. Economic substance in the context of a GAAR analysis does not encompass changes effected by pure tax-saving measures.

In most cases, commercial reality is defined by the legal rights and obligations the taxpayers have created in private law. Thus, the legal form and substance of the transactions are controlling. In other words, in ordinary business and commercial transactions, economic substance is consistent with legal substance. In tax shelters and other structures that are designed solely to achieve tax savings, legal substance and economic substance are divorced.

The “legal substance” of a transaction is primarily a legal question. In *Continental Bank of Canada et al. v. The Queen*,<sup>75</sup> Bowman J (as he then was) held that the requirement to consider “substance over form” in income tax law does not mean that the legal effect of a transaction is irrelevant, nor does it mean that one is entitled to treat substance as synonymous with economic effect.<sup>76</sup> Therefore, “legal substance” analysis involves a determination that arises from considering the legal formulation adopted by the taxpayer for an event and the evidence as to whether the taxpayer acted or behaved in a fashion consistent with the rights and obligations formulated in the documentation.

73 Supra note 2, paragraph 56.

74 David Laro, “Economic Substance: A View from the Tax Court” (2000) vol. 52, no. 1 *The Tax Executive* 44-48, at 45.

75 94 DTC 1858; [1995] 1 CTC 2135 (TCC).

76 Bowman J’s decision was upheld by the Supreme Court of Canada: *Continental Bank Leasing Corporation v. The Queen et al.*, 98 DTC 6505; [1998] 4 CTC 119.

An economic substance analysis goes a step further. In addition to finding out what has happened in accordance with the legal formulation, the taxpayer's transaction must be assessed "with an eye to commercial and economic realities."<sup>77</sup> For example, in a situation similar to that in *Canada Trustco*, in addition to determining whether the legal arrangements are effective and executed as planned, the court would look at whether the economic position of the taxpayer (other than tax savings) would be altered as a result of the transactions.

If the economic substance is clearly different from the legal substance, the former should be the basis for determining the tax consequences. In many GAAR cases, the taxpayer's aim was to create a tax benefit in the form of a loss, expense, or exclusion from gross income that has no economic corollary but is simply the consequence of taking advantage of the tax rules. Other than the transaction costs, the taxpayer really had little to lose.

### Meaning of "Economic Substance"

In *Evans v. The Queen*, Bowman CJ attempted to define the term "economic substance" as follows:

By economic substance I do not intend to import into this criterion a business purpose test. The Supreme Court of Canada did not do so. Rather, I think what was meant was that a genuine change in legal and economic relations took place as the result of the transactions.<sup>78</sup>

This interpretation of economic substance is unclear. First of all, it fails to clarify why business purpose is not imported into the economic substance inquiry. Presumably Bowman CJ appreciated the fact that subsection 245(3) already codifies the "business purpose" or "bona fide purposes" test, so that it is unnecessary to incorporate this test in the economic substance inquiry for the purpose of subsection 245(4). As a general concept, however, it would make sense to examine both the non-tax-purpose/motive and the non-tax-profit/outcome of transactions.<sup>79</sup>

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77 *Bronfman Trust*, supra note 39, at 5067; 128, quoted in *The Queen v. Singleton*, 2001 DTC 5533; [2002] 1 CTC 121, at paragraph 51 (SCC) (per LeBel J).

78 *Evans*, supra note 15, at paragraph 35.

79 The US courts have developed a "two-prong test" for determining whether a transaction lacks economic substance: the objective prong looks at whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits; and the subjective prong looks at whether the taxpayer has shown that it had a business purpose for engaging in the transaction other than tax avoidance. This article is not intended to provide a comprehensive review of the US jurisprudence and literature on economic substance. For some interesting work on this subject, see Marvin A. Chirelstein and Lawrence A. Zelenak, "Tax Shelters and the Search for a Silver Bullet" (2005) vol. 105, no. 6 *Columbia Law Review* 1939-66; Hariton, supra note 53; Isenbergh, supra note 53; Yoram Keinan, "The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?" (2005) vol. 1, no. 2 *New York University Journal of Law and Business* 371-456; Allen D. Madison, "The Tension Between Textualism and

With respect to the determination of economic substance, the inquiry should emphasize the economic result and outcome, as well as the “economic relations.” If the taxpayer’s economic position was not meaningfully altered by the transaction, or if there was no real economic reason for the transaction (other than tax-saving considerations), it is difficult to find economic substance in the transaction. Therefore, a transaction lacks economic substance if “the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement).”<sup>80</sup> In other words, a transaction lacks economic substance if it did not expose the taxpayer to any economic risk, or offer the taxpayer any opportunity for profit, that was meaningful in relation to the resulting tax benefit. All in all, a transaction has no economic substance if it was simply a “game,” as described by Lord Templeman in the UK *Ramsay* case:

The game is recognisable by four rules. First, the play is devised and scripted prior to the performance. Secondly, real money and real documents are circulated and exchanged. Thirdly, the money is returned by the end of the performance. Fourthly, the financial position of the actors is the same at the end as it was in the beginning save that the taxpayer in the course of the performance pays the hired actors for their services. The object of the performance is to create the illusion that something has happened, that Hamlet has been killed and that Bottom did don an asses head so that tax advantage can be claimed as if something had happened.<sup>81</sup>

Leaving aside the definitional issue, Bowman CJ’s economic analysis in the *Evans* case is problematic. Without much analysis, he found that the series of transactions designed to “put the corporate funds in Dr. Evans’ hands” (that is, surplus-stripping transactions) did not lack economic substance.<sup>82</sup> His approach was not much different from the traditional legal substance analysis. He did not examine any economic evidence. Instead, he seemed to infer economic substance from the legally effective arrangements:

The transactions do not lack economic substance. The transactions were real and legally effective. They are not shams.<sup>83</sup>

A transaction that is legally effective and not a sham in a legal sense may nevertheless be an economic or a substantive sham. Only an economic analysis can establish

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Substance-Over-Form Doctrines in Tax Law” (2003) vol. 43, no. 3 *Santa Clara Law Review* 699-750; Patton, *supra* note 53; Larry R. Scott, “Sale-Leaseback v. Mere Financing: Lyon’s Roar and the Aftermath” [1982] no. 4 *University of Illinois Law Review* 1075-1104; Smith, *supra* note 59; and Alvin C. Warren Jr., “The Requirement of Economic Profit in Tax Motivated Transactions” (1981) vol. 59, no. 12 *Taxes: The Tax Magazine* 985-92, at 989.

80 *CIR v. Challenge Corporation Ltd.*, [1987] 1 AC 155, at 168 (PC) (per Lord Templeman).

81 *WT. Ramsay v. IRC*, [1979] 3 All ER 213, at 214-15 (CA).

82 *Evans*, *supra* note 15, at paragraph 22.

83 *Ibid.*, at paragraph 35.



the economic substance of the transaction. As noted by Bowman CJ, in the *Evans* case the sole purpose of the transactions was to put the corporate funds in Dr. Evans's hands (a transaction that is normally characterized as a distribution of corporate income, which is taxable as a dividend). The series of transactions was designed to effect the transfer of funds at the least tax cost, by skilfully avoiding the literal application of various anti-surplus-stripping provisions of the Act. It is clear that the only economic benefit arising from the transactions was tax savings.

## WHAT ARE THE RELEVANT FACTORS IN DETERMINING ECONOMIC SUBSTANCE?

The Supreme Court correctly observed that the line between abusive tax avoidance and legitimate tax planning “is far from bright.”<sup>84</sup> In this part of the article, I argue that the line can be made much brighter through an economic substance analysis, for two reasons. First, the standard of inquiry is the “reasonable person” or “prudent investor” test. Subsection 245(4) specifically refers to the reasonable standard. In other words, the economic substance determination is not a subjective reconstruction of the taxpayer's transactions. Second, the inquiry is based on objective economic factors that are the typical hallmarks of market-based transactions—expected pre-tax (or non-tax) profit, risk, and tax-indifferent parties or intermediaries—each of which is discussed below.

### Pre-Tax Profit

The pursuit of profit is a key feature of any business. A transaction has economic substance if it provides an economic benefit of some consequence to the taxpayer separate and apart from tax savings. In tax shelter cases, the crucial question is how much profit is enough; obviously, a dollar's worth of economic profit is insufficient.<sup>85</sup> Another question is how to measure pre-tax profit. Unfortunately, there is no clear answer to this question, even in the United States, where the jurisprudence on the economic substance doctrine is most fully developed. It is not that the US courts have come out differently on the question; rather, no tax shelter case has yet involved any positive return, once transaction costs are taken into consideration.<sup>86</sup> However, the US jurisprudence can provide some guidance on the application of

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84 *Canada Trustco*, supra note 2, at paragraph 16.

85 Warren, supra note 79, at 989.

86 Joseph Bankman, “The Economic Substance Doctrine” (2000) vol. 74, no. 1 *Southern California Law Review* 5-30, at 23. With respect to the measurement of pre-tax profit, US proposed rules that were intended to codify the economic substance doctrine suggested the use of at least a risk-free rate of return (proposed section 7701(n)(1)(B) of the Jumpstart Our Business Strength (JOBS) Act, S 1637, 108th Cong., 1st sess., November 7, 2003). The rationale for this test is that the taxpayer has placed some of its money at risk. In many of the tax shelter cases in the United States, the taxpayer not only had negative returns after transaction costs, but had also hedged away the possibility of any upside or downside risk.

economic substance analysis in cases involving tax-avoidance transactions not unlike those in *Mathew* and *Canada Trustco*.

*Long Term Capital Holdings*<sup>87</sup> is one of the more recent US tax-avoidance cases in which economic substance has been considered.<sup>88</sup> It is rather ironic that an arrangement designed by the renowned economist and Nobel prize winner Myron S. Scholes was found to lack economic substance. The essence of the arrangement was to allow loss duplication through the contribution of preferred stock with a built-in loss to a partnership, the sale of the contributor’s partnership interest to the general partner, and the subsequent sale of the loss stock by the partnership. The transactions involving the taxpayer, Long Term Capital Holdings (“Long Term”), included the following:

- In 1996, Onslow Trading and Commercial LLC (“OTC”) transferred the preferred stock to Long Term Capital Partners LP (“LTCP”), a hedge fund, in exchange for a partnership interest in LTCP. OTC borrowed the cash component of its contribution from Long Term Capital Management UK (“LTCM”), a UK entity related to LTCP. OTC also purchased from LTCM a put option with respect to its interest in LTCP.
- LTCP in turn contributed the preferred stock to a lower-tier partnership called Portfolio. Both LTCP and Portfolio claimed that OTC’s \$107 million basis in the stock carried over to them in a tax-free transaction (by virtue of section 721 of the Internal Revenue Code).
- At the end of 1997, Portfolio sold the preferred stock to an investment bank (“B&B”) for approximately \$1 million, producing a loss of \$106 million.
- Portfolio allocated the capital loss to LTCP, which then allocated the loss to LTCM.

The arranger of this deal received a partnership interest in LTCP and a consulting fee of \$1.2 million. Another consultant earned a fee of \$1.8 million. LTCM earned fees for assets under management, proportional to the return achieved for the investors. The taxpayer, Long Term, relied on the additional fees it would earn from both OTC and sufficient investment in B&B to justify its ability to earn a pre-tax return.

The US District Court for the District of Connecticut held that OTC’s contribution of the preferred stock to LTCP, OTC’s sale of its partnership interest to LTCM, and Portfolio’s subsequent sale of the preferred stock to B&B lacked economic substance and must be disregarded for federal income tax purposes. In the alternative, the court held that the transactions must be recast under the step transaction

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87 *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, at 139 (D. Conn. 2004); aff’d, 2005 US App. Lexis 20988 (2d Cir. 2005).

88 In US tax law, a transaction lacks economic substance if it “can not with reason be said to have purpose, substance, or utility apart from [its] anticipated tax consequence”: *Goldstein v. CIR*, 364 F. 2d 734, at 740 (2d Cir. 1966). Transactions or arrangements may be disregarded if they lack economic substance: see *Compaq Computer Corp.*, 113 TC 214, at 224 (1999).

doctrine as a taxable sale by OTC directly to LTCM. The court also upheld a 40 percent penalty for gross valuation misstatement.

With respect to the objective economic substance test, the taxpayer argued that the test ought to be whether there was a meaningful change in the taxpayer's economic position. The court rejected this argument and held that "[t]he test should be whether there was a 'reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.'"<sup>89</sup> The court applied a cost-benefit analysis and held that it was not reasonable for the taxpayer to expect a non-tax-based profit from the transactions, given the hefty transactional costs incurred. The court compared the potential profit with the sizable amounts paid as attorney fees, consultant fees, partnership distributions, bonuses, and related-party loans. In establishing the potential profit, the court generously assumed LTCP's above-market returns (which the hedge fund was known for), but excluded certain management fees (including only the management fees that LTCM could earn on the OTC investment) and ignored the economic value of partner relationships. This cost-benefit analysis led the court to conclude that the transaction lacked economic substance simply because no prudent investor would knowingly and intentionally incur costs above a reasonable gain.

The taxpayer, Long Term, argued that it was motivated to enter into the OTC transaction primarily by the management fees it could earn from OTC and the return on its B&B investment. Long Term also stressed that accepting investments was its core business. The court was not persuaded:

As analyzed above, the evidence of claimed reasonableness of the purported primary motivation, fees, is unpersuasive—a prudent investor would not have made the deal. The absence of reasonableness sheds light on Long Term's subjective motivation, particularly given the high level of sophistication possessed by Long Term's principals in matters economic. This is demonstrated, for example, by Scholes' concession that some of Long Term's principals viewed the added value of OTC and B&B solely to be anticipated tax benefits. Moreover, the construction of an elaborate, time consuming, inefficient and expensive transactions with OTC for the purported purpose of generating fees itself points to Long Term's true motivation, tax avoidance.<sup>90</sup>

The *Long Term Capital Holdings* case is similar to *Mathew* in that the loss was "transferred" to the partnership and the amount of tax savings vastly exceeded any pre-tax return on the investment. Two older cases, *Rice's Toyota World, Inc.*<sup>91</sup> and *Frank Lyon Co.*,<sup>92</sup> dealt with the application of economic substance analysis in considering pre-tax profit with respect to sale and leaseback transactions.

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89 *Supra* note 87, at 139 (D. Conn.).

90 *Ibid.*, at 186.

91 81 TC 184 (1983); *aff'd.* in part, *rev'd.* in part, 752 F. 2d 89 (4th Cir. 1985).

92 *Frank Lyon Co. v. United States*, 435 US 561 (1978).

In *Rice’s Toyota World, Inc.*, the taxpayer purchased a used computer through a credit arrangement with a leasing company consisting of approximately 80 percent non-recourse and 20 percent full recourse debt. After purchasing the computer, the taxpayer leased it back to the leasing company. The US courts found that the transaction lacked economic substance because the taxpayer could not realize any economic value from the transaction. The finding rested on the taxpayer’s failure to determine that the residual value in the computer was sufficient to generate a profit.

In *Frank Lyon Co.*, the US Supreme Court held that the sale-leaseback transaction had economic substance. In this case, the taxpayer (Lyon) borrowed \$7.1 million, bought a building from a bank for \$7.6 million (the loan plus \$500,000 of the taxpayer’s own funds), and leased the building back to a bank for rent equal to the taxpayer’s payments of principal and interest on the \$7.1 million loan. The initial term of the lease was 25 years, with options to extend it up to a maximum of 65 years. The lease agreement also provided the taxpayer with a fixed rate of return on its \$500,000 investment. At the end of the lease term, the bank could either acquire the building or extend the lease. The taxpayer claimed depreciation deductions from building and interest deductions on the loan, and reported the payments from the bank as income from rent. The US Supreme Court stated:

In short, we hold that where, 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.<sup>93</sup>

Had the Supreme Court of Canada engaged in an economic analysis of the transaction in *Canada Trustco*, it would have considered whether the predetermined rate of leasing fees (which was fixed at the interest rate plus 1 percent) could possibly have produced a pre-tax profit for the taxpayer. On the basis of the facts described in the case, this rate did not take into account the principal of the loan from the bank (as in *Frank Lyon Co.*) or the residual value of the leased property (as in *Rice’s Toyota World, Inc.*). It is difficult to imagine that *Canada Trustco* would have earned any pre-tax profit, considering the huge amount of the CCA deduction (\$31,196,700 for the 1997 taxation year), interest expense deduction, and the transaction costs (including fees paid to the arranger of the transactions).

Related to the pre-tax profit factor is the comparison of pre-tax profit with the amount of tax savings. A transaction generally lacks economic substance unless

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93 *Ibid.*, at 583-84. This decision has been criticized for overlooking the point that the regulatory considerations that outweighed taking into account Lyon’s limited economic stake were those of the bank, not of Lyon. Lyon’s real reward was the value of the tax attributes—deductions for depreciation and interest. In return for those, it was willing to give up any pre-tax profit. See Charles I. Kingson, “How Tax Thinks” (2004) vol. 37, no. 4 *Suffolk University Law Review* 1031-40, at 1039.

the pre-tax profit from the transaction is substantial in relation to the net tax benefits. In *Mathew*, the Supreme Court noted that the taxpayers deducted losses exceeding \$10 million, while their cost of investment was about \$1.5 million; however, the court's decision did not rest on this fact.<sup>94</sup>

### Risk and Market Forces

If there is no real possibility that the taxpayer will gain or lose, or if all the risks—indeed, the type of risks that are encountered daily in real business transactions—have been hedged, then it is likely that there is no economic substance to the transaction. To put it slightly differently, a transaction lacks real economic substance if the transactions and steps are so “pre-wired” or so certain to occur that there are no real market forces at work. The occurrence or timing of any of the steps is a function of anything other than planning. There are no supervening market forces or other non-tax considerations that could disrupt the scheduled execution of the planned steps. Naturally, wise business planning necessitates careful identification and consideration of possible risks. One should expect that sophisticated financial officers will anticipate future events and plan for them. However, if the planning virtually eliminates the market risk normally present in business transactions, one may rightly become suspicious that the deal lacks economic substance other than the tax benefits.

When examined in the light of risk and market forces, it is obvious that the transaction in *Canada Trustco* had no economic substance. The transactions were preordained; the loan from the bank was effectively repaid in its entirety on the day it was made when Canada Trustco assigned the rent payments; there was no risk that the rent payments would not be made, because the funds came originally from Canada Trustco; and Canada Trustco's own contribution to the deal and its transaction costs (\$5.9 million in fees) were fully covered by the bond.<sup>95</sup>

### Indifferent Parties and Intermediaries

The fact that a transaction was designed by an arranger or involves a tax-indifferent party or special-purpose entity is a relevant factor in determining economic substance. As Lord Diplock observed in *IRC v. Burmah*,

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94 In *OSFC Holdings Ltd.*, supra note 30, at paragraph 51, Rothstein JA held that the significant disparity between the potential tax benefit to the taxpayer of about \$52 million and expected returns from the operation and disposition of the STIL II portfolio showed that the taxpayer's acquisition of Standard Trust's 99 percent interest in the STIL II partnership was not undertaken primarily for bona fide purposes other than to obtain the tax benefit.

95 The Supreme Court held against the minister on the ground that “cost” for the purposes of the CCA provisions did not mean “at risk amount.” However, the court did not find that the \$120 million was at any economic risk. In this respect, the minister's submission succinctly described the risk-free character of the transaction. *Canada Trustco*, supra note 2, at paragraph 70.

[t]he kinds of tax-avoidance schemes that have occupied the attention of the courts in recent years . . . involve inter-connected transactions between artificial persons, limited companies, without minds of their own but directed by a single master-mind.<sup>96</sup>

Therefore, the involvement of a tax-indifferent intermediary may raise the suspicion that the sole function of the intermediary is to serve the interest of tax avoidance.

In *Canada Trustco*, the deal was designed and sold to the taxpayer by an arranger (Macquarie Corporate Finance (USA) Inc.). The original owner of the trailers (TLI) was indifferent to the tax treatment of Canada Trustco and seemed a willing participant for a fee of over \$3.6 million. MAIL was a special-purpose entity established to facilitate the transactions. In *Evans*, all the parties involved were controlled by Dr. Evans's family, including his wife and children. Indifferent parties have been used in other transactions attacked under the GAAR.<sup>97</sup>

### Ordinary Business Transactions

None of the above factors is conclusive. The determination of economic substance should be made on the basis of all of the relevant factors.

At one end of the spectrum, a transaction has all the usual commercial features and is clearly an “ordinary business transaction” with economic substance. The GAAR is not intended to interfere with legitimate business transactions, even when they are tax-motivated. It does not take away the taxpayer's right to tax planning in order to take advantage of certain loopholes that naturally present themselves in the course of business operations.

At the other end of the spectrum, if a transaction is designed to produce a loss (that is, the pre-tax profit is less than the transaction costs), or even to produce pre-tax losses, and no independent business person would enter into the transaction without the tax benefit, the transaction will lack economic substance. This is typically referred to as a “tax shelter.” The economic substance analysis is most effective when it is applied to tax shelters and other closed investments where the taxpayer is not already engaged in the particular subject of the investment and stands to profit (if at all) only from the particular investment. An example would be a case where a taxpayer structured its investment to generate a loss that would serve to offset the tax on completely unrelated income and the transaction gave rise to a loss that dwarfed the business objectives of the taxpayer and any profits arising from them. These are the so-called loss generators (for example, the transactions in *Long Term Capital Holdings*).<sup>98</sup> “An economic substance case that involves a publicly

96 [1982] STC 30, at 32 (HL).

97 For example, *McNichol et al. v. The Queen*, 97 DTC 111; [1997] 2 CTC 2088 (TCC); *Water's Edge Village Estates (Phase II) Ltd. v. The Queen*, 2002 DTC 7172; [2002] 4 CTC 1 (FCA); and *RMM Canadian Enterprises Inc. et al. v. The Queen*, 97 DTC 302; [1998] 1 CTC 2300 (TCC).

98 For a review of these cases, see Bankman, *supra* note 86, at 21; and Keinan, *supra* note 79.

marketed shelter and a billion dollar price tag is hard to defend as taxpayer's counsel—on that most tax lawyers would agree.”<sup>99</sup>

In between typical ordinary business transactions and tax shelters, there is a range of transactions with mixed tax and non-tax motives and substance. As in other areas of tax law, the courts must examine all the relevant facts and circumstances and determine the predominant motive and outcome of the transaction. For example, in *UPS v. Commissioner*,<sup>100</sup> a purely tax-motivated transaction was upheld. In this case, the taxpayer was engaged in the exceedingly profitable business of selling parcel insurance. The premiums collected in exchange for providing such insurance are taxable income. In order to minimize its tax on the insurance profit, UPS restructured its insurance program by insuring the risks with an unrelated insurer; as a result, UPS paid the entire premiums over to the insurer and deducted the payment as an expense. The unrelated insurer reinsured the risk with a Bermuda company that had been formed by UPS, which then distributed the profits to UPS shareholders. As a result, the insurance premiums that UPS had previously reported in its income were being reported by an offshore insurance company that was owned by UPS shareholders. The Eleventh Circuit of the Federal Court of Appeal held that restructuring should be respected for tax purposes. The court found that there were necessary “economic effects” because UPS was obliged to pay the unrelated insurer and the insurer could proceed against UPS if the insurer defaulted. The insurer also bore the risk of default by the Bermuda company on its obligations under the reinsurance agreement. The court held that the restructuring had the necessary business purpose because “when we are talking about a going concern like UPS,” the transaction has a business purpose “as long as it figures in a bona fide, profit-seeking business.”<sup>101</sup>

## HOW CAN THE COURTS APPLY AN ECONOMIC SUBSTANCE ANALYSIS IN GAAR CASES?

Having discussed why an economic substance analysis is important to the application of the GAAR, what economic substance means, and how economic substance can be determined, I will now turn to the question of how the courts can incorporate an economic substance analysis in their GAAR decisions. This part of the article focuses on three issues:

1. At which stage of the GAAR analysis should the courts consider the economic substance of transactions?
2. What are the types of provisions that make it imperative for the courts to examine economic substance?
3. Where do the courts find their precedents?

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99 Bankman, *supra* note 86, at 22.

100 254 F. 3d 1014 (11th Cir. 2001).

101 *Ibid.*, at 1019.

### **Economic Substance Analysis Under Subsection 245(4)**

The Supreme Court seemed to allow the application of an economic substance analysis at various stages of the GAAR analysis. As discussed above, however, because recharacterization of taxpayer’s transactions is generally prohibited unless subsection 245(4) applies, the economic substance analysis is most important to the determination of abuse within the meaning of that provision.

Whether a transaction lacking economic substance constitutes an abusive transaction under subsection 245(4) is controlled by the legislative purpose and intent of the provisions of the Act. As a general proposition, unless the relevant provisions of the Act are intended to permit the enjoyment of a tax benefit resulting from a transaction that lacks economic substance, such a transaction should be presumed to be abusive. In contrast, a transaction that is clearly supported by the text, intent, and purpose of the statute will withstand the GAAR whether or not it otherwise meets the economic substance test.<sup>102</sup>

For example, the transaction in *Mathew* clearly lacked any economic substance. The partners of partnership B paid about \$1.5 million to acquire interests in the partnership in order to gain access to the tax losses, but they deducted losses of over \$10 million.<sup>103</sup> Other than the tax savings, there was no evidence of any significant return on their investment. However, the investment was “profitable” when the value of the loss deduction was taken into account. Allowing the taxpayer to succeed in *Mathew* would amount to allowing taxpayers to intentionally expend far more than could reasonably be expected to be recouped through non-tax economic returns in a transaction whose sole motivation is tax avoidance. That would clearly defeat the purpose of the GAAR.

Ultimately, whether or not the GAAR is applicable in a given situation is a question of statutory interpretation. Ambiguities are inherent to the exercise of statutory interpretation. Litigation, especially before the Supreme Court, often involves interpretative issues that are not very clear. Ambiguity may arise from different approaches to statutory interpretation. A liberal, purposive interpretation may reveal a broader purpose that requires the transaction to have real economic substance, while a literal interpretation of the specific provisions may not impose the same requirement. Ambiguity may also arise where the provisions of the Act read as a whole may not reveal any coherent policy or purpose, but rather contain a number of anomalous and inconsistent ad hoc measures adopted in response to particular cases, budget initiatives, immediate revenue needs, or lobbying by special-interest groups. The Supreme Court made it clear that in such cases a finding of abuse is warranted only where it cannot reasonably be concluded that the avoidance

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102 Bankman, *supra* note 86, at 11.

103 The appellants in this case deducted over \$10 million of the losses against their own incomes. Some of appellants, in addition to reducing their taxable income for the relevant year to nil, also generated a non-capital loss to be carried over to other years.



transaction was consistent with the object, spirit, or purpose of the provisions of the Act. “[T]he abusive nature of the transaction must be clear.”<sup>104</sup>

### Types of Tax Provisions Requiring Economic Substance

While it may be helpful to conduct an economic analysis in all cases, this analysis is particularly relevant to statutory provisions that contain terms or concepts that draw their meaning from commercial life. In interpreting these provisions, the ultimate question is what it is that taxpayers have actually done. Because it is often not possible to define a transaction or a concept with enough specificity, Parliament may simply use a common commercial term instead of enumerating the requirements that a taxpayer must meet in order to receive a tax deduction or other benefits. When a taxpayer claims a benefit under this type of statutory provision, the courts should define the term by referring to “[l]ife in all its fullness”<sup>105</sup> because “that is where the term originated.”<sup>106</sup>

Lord Hoffmann has described the proper approach to statutory interpretation in the following terms:

If the statute required something which had a real commercial existence, like a profit or loss, then a series of preordained transactions which taken together produced no profit or loss would not satisfy the statute. On the other hand, if all that the statute required was something which had a particular legal effect, like discharging a debt or passing title to property, then a transaction which had that effect satisfied the statute even it had no business purpose.<sup>107</sup>

The distinction between terms of art and real terms is “not an unreasonable generalisation,” but it should not “provide a substitute for a close analysis of what the statute means.”<sup>108</sup> Indeed, that “would be the very negation of purposive construction.”<sup>109</sup> The extent to which economic substance analysis is relevant in a GAAR case depends on the court’s interpretation of the legislative purpose.

For example, on a broader interpretation, the purpose of the CCA provisions of the Act is to provide “for the recognition of money spent to acquire qualifying assets to the extent that they are consumed in the income-earning process,”<sup>110</sup> or even to recognize the true economic cost consumed in the income-producing process in order to obtain the “accurate picture” of profit. The broader interpretation

104 *Canada Trustco*, supra note 2, at paragraph 62.

105 *Welch v. Helvering*, 290 US 111, at 115 (1933).

106 Patton, supra note 53, at 515.

107 Leonard Hoffmann, “Tax Avoidance” [2005] no. 2 *British Tax Review* 197-206, at 203. See also Lord Hoffmann’s comments in *MacNiven v. Westmoreland Investments Ltd.*, [2003] 1 AC 311 (HL).

108 *Barclays Finance Ltd. v. Mawson*, [2005] 1 AC 684, at paragraph 38 (HL).

109 *Ibid.*

110 See the Tax Court decision in *Canada Trustco*, supra note 19, at paragraph 60.

is more consistent with the general design of the Act: “provisions of the *Income Tax Act* are intended to apply to transactions with real economic substance.”<sup>111</sup> More specifically, the deduction for CCA is relevant to the calculation of profit under section 9. As the Supreme Court stated in *Canderel Limited v. The Queen*, the goal of profit computation is “to obtain an accurate picture of the taxpayer’s profit for the given year.”<sup>112</sup> Whether the picture of a taxpayer’s profit is accurate or not is measured against commercial reality (for example, financial accounting). In this sense, interpreting the cost of depreciable property to be the amount on paper as opposed to the amount in a real commercial sense would distort the picture of profit. “Profit,” “loss,” and “cost” are perhaps typical terms used in the Act that draw their meaning from commercial life. A broader interpretation of purpose will thus require that the term “cost” be given a meaning that is based on the economic substance of the transactions.

### Precedents for Economic Substance Analysis in Tax Law

Bowman CJ recently remarked in *XCO Investments Ltd. v. The Queen*:

I am aware that economic reality is a concept that under recent jurisprudence is not in favour. Nonetheless it is an important ingredient in a determination of what is reasonable.<sup>113</sup>

In this recent GAAR case, the taxpayers entered into a series of transactions involving the purchase of losses from an indifferent third party (Woodwards) in order to reduce their taxes otherwise payable. After finding that the legal aspects of the arrangements were effective, Bowman CJ examined the economic substance of the transaction. The taxpayers incurred a cost of \$557,556 in order to obtain the participation of Woodward in the arrangement. In return, the taxpayers saved (or would have saved, if the plan had worked) the tax on \$5,867,336 (which was estimated to be well over \$2 million). Without resorting to the GAAR, Bowman CJ denied the tax benefit to the taxpayers by disallowing the allocation of partnership profits to Woodward in excess of its economic contribution pursuant to section 103 of the Act.

Bowman CJ noted that the term “reasonable” is a relative term and what is reasonable must depend on all of the circumstances. The determination of “reasonableness” is clearly not a discretionary act on the part of the minister. The same reasoning applies to the “economic substance” analysis. There is sufficient Canadian jurisprudence on economic analysis or a facts-and-circumstances determination in the context of statutory provisions imposing a “reasonable” test (for example, paragraph 20(1)(c) and sections 67, 67.1, 69, and 247) or provisions that require the

111 *Canada Trustco*, supra note 2, at paragraph 49.

112 98 DTC 6100, at 6110; [1998] 2 CTC 35, at 55 (SCC).

113 2005 TCC 655, at paragraph 35.

courts to adopt the substance-over-form approach (for example, paragraph 12(1)(g) and subsections 16(1), 74.1(1) and (2), and 56(2)).

In addition, Canadian courts have often referred to foreign jurisprudence in interpreting Canadian tax law. The *Duke of Westminster* is perhaps the most often cited non-Canadian case in the area of statutory interpretation and tax avoidance. There is no reason why an application of the GAAR that is intended to “attenuate” the application of the *Duke of Westminster* principle cannot benefit from foreign jurisprudence, especially that of the United States. The enactment of the GAAR can be attributed, in part, to the Supreme Court’s rejection in *Stubart* of the business purpose test and its derivative, the economic substance doctrine in the US case of *Gregory v. Helvering*. Therefore, it is important for Canadian courts to be mindful of US jurisprudence on economic substance, which is perhaps the most sophisticated in common-law jurisdictions.

## CONCLUSIONS

In this article, I have attempted to deal with the questions left unanswered by the Supreme Court of Canada in *Canada Trustco* and *Mathew*. The main argument is that economic substance analysis is not only crucial to any meaningful application of the GAAR, but also capable of objective determination and application. The test for determining economic substance may vary, depending on the facts and circumstances of the case, but this flexibility should not be confused with uncertainty and unpredictability. Economic substance analysis offers the best standard for drawing the line between legitimate tax planning and abusive tax avoidance. Most importantly, Canadian courts can draw from Canadian and foreign jurisprudence in applying an economic substance analysis in tax cases.