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The Misuse or Abuse Exception: The Role of Economic Substance

Jinyan Li
Osgoode Hall Law School of York University, jli@osgoode.yorku.ca

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*Jinyan Li**

Introduction

The "misuse or abuse" exception under subsection 245(4) of the Income Tax Act[1] draws the line between acceptable and unacceptable tax avoidance. As a "safety valve"[2] or "relieving provision,"[3] this exception has proved to be the "most crucial and controversial single factor in the application of the GAAR."[4] Whether a transaction that lacks economic substance is subject to the general anti-avoidance rule (GAAR) is the question considered in this chapter.

The current law on economic substance is unsettled, to put it optimistically. In *Canada Trustco*,[5] the Supreme Court of Canada stated that the relevance of economic substance depends on "the proper interpretation of specific provisions

* Professor, co-director of LLM Tax Program, Osgoode Hall Law School. I thank Scott Wilkie for sharing his insights into the importance of legal substance and economic substance; Thaddeus Hwong for providing feedback on an earlier draft of this chapter; and Nathan Jin Bao and Corey LeBlanc (Osgoode JD students) for providing excellent research assistance.

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

2 Brian J. Arnold, "Policy Forum: The Determination of Abuse under GAAR" (2014) 62:1 *Canadian Tax Journal* 113-27, at 115; Douglas J. Powrie, "GAAR: Its Evolution and Application," in *Report of Proceedings of the Sixty-Second Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2011), 8:1-32, at 8:2.

3 David A. Dodge, "A New and More Coherent Approach to Tax Avoidance" (1988) 36:1 *Canadian Tax Journal* 1-22, at 20.

4 Brian J. Arnold, "General Overview of the General Anti-Avoidance Rule," in chapter 5 of this volume.

5 *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, at paragraphs 56 and 57; aff'g 2004 FCA 67; aff'g 2003 TCC 215. For a critique of this case, see Brian J. Arnold, "Policy Forum: Confusion Worse Confounded—The Supreme Court's GAAR Decisions" (2006) 54:1 *Canadian Tax Journal* 167-209.

of the Act or the relevant factual context of a case."[6] The court provided little guidance, however, on how such relevance should be determined. No other Supreme Court decisions have addressed economic substance per se. Recent Federal Court of Appeal cases have recognized that the foundational provisions of the Act (such as sections 3, 4, 9, and 38) require transactions to have some air of economic reality, and these cases have not recognized losses resulting from paper transactions.[7] The only clear judicial guidance is that a requirement of economic substance is not a stand-alone anti-abuse rule, and that a lack of economic substance is not a proxy for abuse. In short, the pre-GAAR judicial approach to statutory interpretation and the construction of facts seems to persist, which could undermine the intended purpose and effect of the GAAR.

This chapter deals with economic substance as a matter of statutory interpretation. "Economic substance" refers to an economic (non-tax) purpose and an economic (non-tax) result or effect. I suggest in this chapter that in all abuse cases, economic substance should be considered in order to give effect to the purpose of the GAAR. More specifically, I propose that a unified purposive approach should apply to the construction of both the law and the facts, and that specific provisions of the Act should receive an "organic" interpretation—that is, an interpretation that is sensitive to the typology of the provision and the provision's organic evolution and relationship with other provisions. Further, I suggest that the relevance of economic substance depends on the provision's intent. For a revenue-raising provision (that is, a provision that is part of the scheme designed to raise tax revenue), a transaction lacking economic substance is presumptively abusive. For a tax-expenditure provision or a specific anti-avoidance rule (SAAR), the economic effect of an avoidance transaction is tested against the intended effect of the provision: if the effect of the transaction falls outside the intended scope of a tax-expenditure provision or falls within the intended scope of a SAAR, abuse will likely be found.

Following this introduction, the next section of this chapter provides a critical overview of the role of the GAAR and the current state of the law on economic substance. Next, the chapter makes the case for considering economic substance through a disciplined and rigorous exercise of statutory interpretation. A typology of the substantive provisions of the Act is established (namely, revenue-raising provisions, tax-incentive provisions, and SAARs), followed by an explanation of the various ways in which economic substance is relevant to different types of provisions. The chapter concludes with an analysis of the *Canada Trustco* case, showing how the approach proposed in this chapter would have worked in that case.

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6 *Canada Trustco*, supra note 5, at paragraph 60 (SCC).

7 See, for example, *Triad Gestco Ltd. v. Canada*, 2012 FCA 258 and *Canada v. Global Equity Fund Ltd.*, 2012 FCA 272.

The GAAR and Judicial Approaches to Economic Substance

The GAAR's Transformative Role

A NEW DIRECTION FOR STATUTORY INTERPRETATION

Section 245 signified "a new approach to tax avoidance in Canada,"[8] and it was adopted because the government had become convinced that a change in direction was required to reduce aggressive tax avoidance and to protect the tax base and the fairness of the tax system.[9] This new direction is evident in subsections 245(3) and 245(4).

Subsection 245(3) defines an "avoidance transaction" by reference to a taxpayer's primary purpose, which is established on the basis of objective facts. In effect, by enacting the GAAR, Parliament sought to initiate a paradigm shift for construing facts or transactions for tax purposes: it was thought that the traditional approach—legalistic, form-over-substance, and transaction-by-transaction—must give way to a purposive construction of the facts through an examination of the purpose motivating the legal form used and the transactions in a series of transactions. The impetus for this paradigm shift was the Supreme Court's rejection of the business purpose test in *Stubart*[10] and the fact that post-*Stubart* tax planning had not been affected by the court's adoption of the modern rule of statutory interpretation.[11]

Subsection 245(4) requires a purposive construction of tax statutes (the Act, regulations, and tax treaties) through the misuse or abuse test.[12] This is not a new direction, since the purposive-interpretation approach (that is, the modern rule of statutory interpretation) had already been adopted in *Stubart*. Subsection 245(4), however, elevates a judicial doctrine into a legislative test, with the aim of nudging the courts to play a greater role in addressing aggressive tax avoidance. This has been perceived by some judges as imposing an "unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer."[13]

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8 Dodge, supra note 3, at 2.

9 Canada, Department of Finance, *The White Paper: Tax Reform 1987* (Ottawa: Department of Finance, June 18, 1987).

10 *Stubart Investments Ltd. v. The Queen*, [1984] 1 SCR 536.

11 Dodge, supra note 3, at 18. See also Deen Olsen and Perry Derksen, "The Historical Legal Context for the Enactment of the General Anti-Avoidance Rule: Judicial Anti-Avoidance Doctrines and Statutory Anti-Avoidance Rules," in chapter 2 of this volume.

12 The GAAR does not give the judiciary the duty or power to "legislate" by filling legislative gaps or imputing a special overarching meaning to undefined expressions such as "income," "profit," or "loss." See *Canada Trustco*, supra note 5, at paragraph 41 (SCC), and *Global Equity*, supra note 7, at paragraph 59.

13 *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, at paragraph 66.

Section 245 requires a determination of the purpose of both statutory provisions and taxpayers' transactions. In effect, Parliament has legislated a coherent approach to interpreting the facts and the law while preserving taxpayers' entitlement to benefit from legislative ambiguity and the right to minimize taxation.

This coherent approach—and the corresponding end of the incoherent judicial approach—is perhaps the most profound effect of the GAAR. Where a taxpayer's purpose is to defeat or undermine Parliament's purpose, the GAAR ensures that Parliament's purpose prevails. The key to this approach is to decipher Parliament's purpose when the provisions of the Act are read as a whole or when a specific provision is interpreted textually and contextually.

A REMINDER OF THE PURPOSES OF THE ACT

Protecting the tax base (that is, maintaining revenue-raising capacity) and protecting the fairness of the tax system are the primary stated objectives of the GAAR.[14] Thus the GAAR reminds us that these purposes are fundamental to the Act itself, evident in its origin, architecture, and evolution.[15] The Income War Tax Act (IWTA) was first enacted in 1917 to raise revenue and to fairly share among Canadians the collective burden of financing the First World War.[16] The Act remains the most important instrument for raising revenue in Canada.[17]

Fairness has long been the bedrock of the income tax system. The notion of fairness in tax law can be understood as having two aspects: a substantive sense of fairness, reflecting the principle of ability to pay and distributive justice; and procedural fairness, reflecting the rule of law and taxpayers' right to have tax laws that are certain and predictable. The IWTA became the Income Tax Act in 1948, when income tax was understood to have become a "mass" or "democratic" tax.[18]

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14 Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax (Bill C-139)* (Ottawa: Department of Finance, June 1988), at clause 186; *Canada Trustco*, supra note 5, at paragraph 60 (SCC).

15 Jinyan Li and J. Scott Wilkie, "Celebrating the Centennial of the Income War Tax Act, 1917: The Future Seen by the Light of 100 Candles," in Jinyan Li, J. Scott Wilkie, and Larry F. Chapman, eds., *Income Tax at 100 Years: Essays and Reflections on the Income War Tax Act* (Toronto: Canadian Tax Foundation, 2017), 1:1-18.

16 Colin Campbell and Robert Raizenne, "The 1917 Income War Tax Act: Origins and Enactment," in *Income Tax at 100 Years*, supra note 15, 2:1-96; Income War Tax Act, SC 1917, c. 28 (herein referred to as "the 1917 IWTA").

17 Income tax revenues account for 67.3 percent of total revenues of Canada in the 2018-19 fiscal year: see "Public Accounts of Canada," included in Canada, Department of Finance, "Annual Financial Report of the Government of Canada Fiscal Year 2018-2019" (www.canada.ca/en/department-finance/services/publications/annual-financial-report/2019/report.html).

18 Colin Campbell, "J.L. Ilsley and the Transition to the Post-War Tax System: 1943-1946" (2015) 63:1 *Canadian Tax Journal* 1-52.

When capital gains became taxable under the 1972 Act, fairness based on the ability-to-pay principle was a key justification for the change. The Carter report states:

> Unless a tax system is generally accepted as fair, the fundamental purpose of taxation is lost; for if fairness is not considered relevant there are certainly simpler means for the government to secure command over goods and services . . . it is also clear from the record of the past that a social and political system cannot be strong and enduring when a people becomes convinced that its tax structure does not distribute the tax burden fairly among all citizens.[19]

Parliament frequently uses the Act not only as a means of raising revenue fairly but also as a policy instrument for providing incentives to taxpayers or for implementing income-support programs, such as the Canada child benefit. "[T]axing statutes," as the Tax Court has said, "have economic and social objectives that far transcend the mere raising of money."[20] Thus, the Act has a "dual aspect"; it is both a revenue-raising device and a policy instrument for spending money.[21]

These purposes are rarely explicitly stated by Parliament, but they are evident in the Act, embedded in the wording and arrangement of its provisions and coming into view when the GAAR is deployed.

The Judicial Approach to Economic Substance

THE SUPREME COURT DECISIONS

About half of the GAAR cases decided since 1997 have found the GAAR applicable. Among these cases are *Mathew*,[22] *Lipson*,[23] and *Copthorne*,[24] all decided by the Supreme Court. Revenue-raising provisions and SAARs are the provisions most commonly found to have been abused (see the appendix to this chapter).[25] The

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19 Canada, Royal Commission on Taxation, *Report of the Royal Commission on Taxation*, vol. 2 (Ottawa: Queen's Printer, 1966) (hereinafter the "Carter report"), at 17.

20 *Hover v. MNR*, 93 DTC 98 (TCC), at 99.

21 *Stubart*, supra note 10, at paragraph 55.

22 *Mathew v. Canada*, 2005 SCC 55 (also known as *Kaulius v. The Queen*, 2005 DTC 5538 (SCC)).

23 *Lipson v. Canada*, 2009 SCC 1.

24 *Copthorne*, supra note 13. For further discussion of *Canada Trustco*, *Mathew*, and *Copthorne*, and of selected GAAR decisions of provincial courts and the Federal Court of Appeal, see Brian R. Carr, Brittany Finn, and Ryan Wolfe, "GAAR: An Economic Test?—The Courts Divide," Corporate Tax Planning feature (2020) 68:1 *Canadian Tax Journal* 351-90.

25 As shown in the appendix to this chapter, the abused provisions are SAARs (14 cases), tax-raising provisions (14 cases), and technical relief/facilitation provisions (2 cases). Note that some cases involve two types of provisions. There are no abuse cases involving tax-incentive or social income-support provisions. The provisions most often abused are those relating to surplus stripping (sections 84, 84.1, and 212.1, and subsection 87(3) (text in parentheses)), loss

only Supreme Court case that directly addressed the issue of economic substance was *Canada Trustco*.

In *Canada Trustco*, the taxpayer bought trailers for Cdn$120 million from a US corporation, Transamerica Leasing Inc. (TLI), primarily with borrowed money. The trailers were "circuitously leased back" to TLI.[26] The taxpayer claimed capital cost allowance (CCA) and deducted interest expense, resulting in losses that were used to offset other income. Miller J of the Tax Court found that the transactions were "not so dissimilar from an ordinary sale-leaseback" and were a "profitable investment in a commercial context."[27] Although he also found the transactions to be avoidance transactions because the obtaining of the CCA deduction "drove the deal," he concluded that there was no abuse of the CCA provisions. Miller J's decision was upheld by the Federal Court of Appeal (orally) in a five-sentence decision, and by a unanimous Supreme Court.[28]

In *Canada Trustco*, the Supreme Court interpreted the CCA provisions as requiring only cost—not "economic cost"—and held that cost "in the context of CCA is a well-understood legal concept."[29] The court stated that "the documents detailing the transaction left no uncertainty as to the relationships between the parties" and the "relationships between the parties as expressed in the relevant documentation were not superfluous elements; they were the very essence of the transaction."[30] The court upheld the Tax Court's conclusion that the tax benefit derived from the avoidance transactions fell within the purpose of the CCA provisions. With respect to the relevance of economic substance in general, the Supreme Court referred to the statement in the explanatory notes that "the provisions of the *Income Tax Act* are intended to apply to transactions with real economic substance,"[31] and the court emphasized the importance of statutory interpretation:

> Although the expression "economic substance" may be open to different interpretations, this statement recognizes that the provisions of the Act were intended to apply to transactions that were executed within the object, spirit and purpose of the provisions that are relied upon for the tax benefit.[32]

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limitation (subsection 18(3)), income shifting (section 74.1 and subsections 75(2) and 100(1)), and computation of income (sections 3, 4, 9, 111, 80, and 83, and subsection 20(16)). The two technical relief provisions abused are subsection 112(1) and clause 256(7)(b)(iii)(B)).

26 *Canada Trustco*, supra note 5, at paragraph 2 (TCC).

27 Ibid., at paragraphs 89 and 57 (TCC).

28 *Canada Trustco*, supra note 5.

29 Ibid., at paragraph 75 (SCC).

30 Ibid., at paragraph 76 (SCC).

31 Ibid., at paragraphs 47, 56, and 57 (SCC).

32 Ibid., at paragraph 56 (SCC).

Although the explanatory notes make reference to the expression "economic substance," section 245(4) does not consider a transaction to result in abusive tax avoidance merely because an economic or commercial purpose is not evident. As previously stated, the GAAR was not intended to outlaw all tax benefits; Parliament intended for many to endure. The central question is whether the transaction was consistent with the purpose of the provisions of the Income Tax Act that are relied on by the taxpayer, when those provisions are properly interpreted in light of their context. Abusive tax avoidance will be established if the transactions frustrate or defeat those purposes.[33]

The Supreme Court did not indicate whether the avoidance transactions had economic substance, although the implication was that they did, because the court found that the transactions were similar to "ordinary sale-leaseback" transactions. The decision seemed to suggest, however, that economic substance is not reflected in the CCA provisions because "cost" is a legal concept. A logical inference to draw from the decision is that even tax-driven transactions lacking economic substance can benefit from CCA deductions and be saved from the application of the GAAR by subsection 245(4).

The other three Supreme Court GAAR cases concern the abuse of SAARs, none of which explicitly refer to economic substance. In *Mathew*, the avoidance transactions were considered to be artificial and vacuous and to have resulted in shifting losses in a context where the combined effect of subsection 18(13) and section 96 is not to allow taxpayers "to preserve and transfer unrealized losses to arm's length parties."[34] In *Lipson*, LeBel J found that the avoidance transactions abused subsection 74.1(1) because they used an anti-avoidance rule to achieve a tax-avoidance result.[35] In *Copthorne*, Rothstein J illuminated the process of textual, contextual, and purposive interpretation by considering the text of subsection 87(3) and a broad range of "contextual clues,"[36] including the paid-up capital (PUC) scheme, the absence of corporate consolidation, the relevance of the statutory scheme for capital gains, the in rem nature of PUC, the rules to prevent artificial increases in PUC, and the interpretive principle of negative implication (*inclusio unius est exclusio alterius*). He concluded that the purpose of subsection 87(3) is "to preclude the preservation of PUC, upon amalgamation, where such preservation would allow a shareholder, on a redemption of shares by the amalgamated corporation, to be paid amounts without liability for tax in excess of the investment of tax-paid funds"[37] (or double-counting the PUC in the subsidiary corporation that is amalgamated

33 Ibid., at paragraph 57 (SCC).

34 *Mathew*, supra note 22, at paragraph 55.

35 *Lipson*, supra note 23, at paragraph 42.

36 This expression was used by Stratas J in *The Queen v. Lehigh Cement Limited*, 2014 FCA 103, at paragraph 52.

37 *Copthorne*, supra note 13, at paragraph 126.

with its parent). Since PUC represents "tax-paid funds" invested by a shareholder in a corporation, the artificial inflation of the PUC through the avoidance transactions is abusive.

Generally speaking, the Supreme Court decisions suggest that economic substance is not a stand-alone test for abuse, but that artificial or vacuous transactions are abusive.

THE FEDERAL COURT OF APPEAL DECISIONS

None of the post-*Canada Trustco* GAAR decisions of the Federal Court of Appeal explicitly consider economic substance. However, the economic nature of tax-deductible losses was considered in *Triad Gestco*,[38] *1207192 Ontario Ltd.*,[39] *Global Equity*,[40] and *2763478 Canada Inc.*;[41] the economic interest of a partner in a partnership was considered in *594710 British Columbia Inc.*;[42] and a terminal loss in the CCA scheme was considered to be a real economic loss in *Landrus*.[43] The Tax Court also considered, in *Pièces automobiles Lecavalier*, the economic nature of the gain of a debtor under section 80.[44] Even though the term "economic loss" or "economic benefit" was not used in the relevant provisions, the courts, guided by the principle of purposive interpretation, deciphered a legislative purpose as both allowing a deduction of economic losses and taxing economic benefits.

The deciphering process adopted by Noël J in *Triad Gestco* and *2763478 Canada Inc.* and by Mainville J in *Global Equity* is illuminating. These cases concern the deduction of pure paper losses generated by value-shifting transactions, and they involve the interpretation of some of the most basic provisions of the Act: paragraph 3(b) in *Triad Gestco* and *2763478 Canada Inc.*, and paragraph 3(d) and sections 9 and 111 in *Global Equity.* In *Triad Gestco*, Noël J considered the following statutory scheme for capital gains and losses:[45]

- a charging rule in paragraph 3(b);
- computational rules under paragraphs 38(b), 39(1)(b), and 40(1)(b), and definitional rules in section 53;
- special rules to deem a realization of gains or losses on a change of use under section 45 and subsection 13(2);

38 *Triad Gestco*, supra note 7.

39 *1207192 Ontario Limited v. Canada*, 2012 FCA 259.

40 *Global Equity*, supra note 7.

41 *2763478 Canada Inc. v. Canada*, 2018 FCA 209.

42 *Canada v. 594710 British Columbia Ltd.*, 2018 FCA 166.

43 *Canada v. Landrus*, 2009 FCA 113.

44 *Pièces automobiles Lecavalier Inc. v. The Queen*, 2013 TCC 310.

45 *Triad Gestco*, supra note 7, at paragraphs 26-36.

- stop-loss rules under subparagraph 40(2)(g)(iii) and subsection 40(3.4) to deny the recognition of losses where property is not disposed of by the taxpayer or continues to be owned by the same economic unit (the taxpayer and an affiliated person);
- policy-oriented rules, such as flowthrough share rules under section 66.1; and
- loss-carryover rules under section 111.

Noël J considered paragraph 3(b) to be the "root" of the scheme.[46] He noted that this provision was introduced in 1972, on the recommendation of the Carter Commission, to tax capital gains as "a form of enrichment."[47] The stop-loss rules are SAARs[48] that are intended to preclude a taxpayer from claiming tax relief for a capital loss. Although the change-of-use rules "facilitate" the transition between different uses of property, and the flowthrough share rules "encourage" resource and mineral exploration, these rules do not "detract from the underlying policy" reflected in the basic charging rules.[49] The object, spirit, and purpose of the basic rules (paragraphs 3(b), 38(b), 39(1)(b), and 40(1)(b)) do not allow a paper loss to be deducted as an allowable capital loss.[50]

Noël J's conclusion about the purpose of paragraph 3(b) and its supporting rules is grounded in a "real-world," as opposed to a make-believe, view of the income tax system;[51] it appreciates the fact that capital gains mean an increase in economic power and are not affected by paper losses,[52] and that statutory interpretation is not a "mechanical exercise."[53]

Mainville J adopted a similar approach in *Global Equity*. He considered sections 3, 4, 9, and 111 to be "basic provisions of the Act":[54]

- Section 3 provides the "basic mechanism for determining a taxpayer's income for a taxation year."

46 *2763478 Canada Inc*, supra note 41, at paragraph 54.

47 Ibid., at paragraph 53.

48 *Triad Gestco*, supra note 7, at paragraph 33.

49 Ibid., at paragraphs 47-49.

50 *2763478 Canada Inc.*, supra note 41, at paragraph 61.

51 In *Triad Gestco*, supra note 7, at paragraph 41, Noël J stated: "In this regard, the comment of the House of Lords in *WT Ramsay Ltd. v. Inland Revenue Commissioners*, [1981] 1 All ER 865, although it was made by reference to capital gain under UK Law, is entirely apposite (p. 873): 'The capital gains tax was created to operate in the real world, not that of make-believe. As I said in *Aberdeen Construction Ltd. v. Inland Revenue Comrs*, [1978] 1 All ER 962 at 996, [1978] AC 885 at 893, [1978] STC 127 at 131, it is a tax on gains.'"

52 *Triad Gestco*, supra note 7, at paragraph 42.

53 Ibid., at paragraph 39.

54 *Global Equity*, supra note 7, at paragraph 53.

- Section 4 sets out a source-by-source requirement for computing income or loss.
- Section 9 provides that income or loss from a business or property is the profit or loss therefrom.
- Section 111 allows a taxpayer to carry over certain losses, including business losses.

Because "income," "profit," and "loss" are undefined in the Act, Mainville J gave a coherent and "common-sense" interpretation of "profit" under subsection 9(1) and "loss" under subsection 9(2), referring to the Supreme Court's decision in *Canderel*: "In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the year."[55] The commonsense principle for the meaning of profit applies equally to losses, and business losses must have "an air of economic or business reality." Therefore, the fundamental rationale underlying these provisions is that "business losses must be grounded in some form of economic or business reality."[56]

The "real-world" view embraced by Mainville J is refreshing:

> Like the proverbial rabbit out of the magician's hat, the loss which occurred as a result of these transactions was pulled out of thin air. These transactions are nothing more than a *paper shuffle* carried out with the purpose of creating an artificial business loss for the purpose of avoiding the payment of taxes otherwise owed on the profits resulting from the real-world business operations of [the taxpayer].[57]

Does this real-world view require transactions to have economic substance, and, if so, how much substance is sufficient? In *Triad Gestco* and *Global Equity*, the paper-shuffling arrangements resulted in no meaningful change in the economic position of the taxpayers and were considered to be artificial and vacuous. Since tax planning is often an intrinsic part of "real-world business operations," how much guidance can be gleaned from these decisions?

THE UNSETTLED STATE OF THE LAW

The current state of the law on economic substance is unsettled. Although the courts have made it clear that economic substance is relevant in a GAAR analysis, they have not yet provided guidance on when it is relevant. Only in an extreme scenario where the avoidance transaction is artificial or vacuous (that is, void of any economic purpose or effect)—for example, a transaction that generates paper losses—does the idea of a transaction's economic substance seem to play a role in determining whether the transaction was abusive.

55 Ibid., at paragraph 62, quoting paragraph 53 of *Canderel Ltd. v. Canada*, [1998] 1 SCR 147.

56 *Global Equity*, supra note 7, at paragraphs 62 and 63.

57 Ibid., at paragraph 67.

The current state of the law on economic substance is also confusing about the approach to discerning legislative purpose. In *Canada Trustco*, the Supreme Court stated that the provisions of the Act "are intended to apply to transactions with real economic substance," but it also stated that "[i]n general, Parliament confers tax benefits under the *Income Tax Act* to promote purposes related to specific activities."[58] This seems to imply that avoiding tax by taking advantage of tax benefits through avoidance transactions would be, "in general," intended by Parliament. This amounts to conflating tax-raising provisions and tax-benefit-conferring (tax relief or tax expenditure) provisions.

The *Canada Trustco* decision is arguably incorrect in its approach to the abuse analysis, given its suggestion that the form or documentation of an avoidance transaction is assessed in relation to the purpose or rationale of the relevant statutory provision:

> [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.[59]

This "wholly dissimilar" test[60] has no legislative or contextual basis. If applied indiscriminately, it could render economic substance irrelevant because few provisions of the Act explicitly require transactions to have economic substance. This approach is tantamount to continuing the pre-GAAR approach to applying the Act. It is true that the Supreme Court did not follow this incoherent approach in *Mathew*, *Lipson*, and *Copthorne*, but the court did not reject it, either.

Economic Substance as a Matter of Statutory Interpretation

The Notion of Economic Substance

The notion of economic substance is undefined in the Act and in the jurisprudence. It can be understood to refer both to an economic (business or bona fide non-tax) purpose and to an economic effect of a transaction.[61] The term "economic purpose"

58 *Canada Trustco*, supra note 5, at paragraph 15 (SCC).

59 Ibid., at paragraph 60 (SCC) (emphasis added).

60 See Arnold, "Confusion Worse Confounded," supra note 5, at 194.

61 For more on economic substance, see Jinyan Li, "'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) 54:1 *Canadian Tax Journal* 23-56; Robert McMechan, *Economic Substance and Tax Avoidance: An International Perspective* (Toronto: Carswell, 2013); and Leandra Lederman, "W(h)ither Economic Substance?" (2010) 95:2 *Iowa Law Review* 389-444.

is used in contrast to a tax-avoidance purpose. The purpose test in the GAAR, as set out in subsection 245(3), requires a bona fide purpose other than the purpose of obtaining a tax benefit. The notion of economic effect, in contrast to legal effect, is used to refer to the economic results of a transaction: that is, to address the question whether a transaction brings about a meaningful change in the economic position of the parties. This aspect of economic substance is missing from section 245 on its face, but its relevance can be gathered from the GAAR jurisprudence that considers the economic nature of income or loss, and from the fact that (for example) PUC means "tax-paid funds" and capital gains represent economic enrichment.

Bifurcating economic substance into an economic purpose and an economic effect or result may help explain its relevance in the context of different types of provisions. For the purposes of analyzing the abuse of revenue-raising provisions, both prongs of economic substance are relevant. For the purposes of analyzing the abuse of tax-expenditure provisions or SAARs, the economic effect is more relevant.

Considering the economic substance of transactions is not the same as recharacterizing transactions: considering economic substance means looking beyond the legal form of transactions in order to determine their purpose or effect. While legal form is relevant, it is not determinative. As suggested below, the relevance of economic substance can be discerned through undertaking a rigorous exercise in statutory interpretation.

Economic Substance Under the Purposive Construction of the Law and the Facts

The abuse analysis under subsection 245(4) involves a determination of the purpose and rationale of the relevant provisions and a determination of whether an avoidance transaction frustrates or defeats that purpose or rationale.[62] Economic substance, understood in terms of economic result or effect, is logically part of the abuse analysis because, as the Supreme Court has consistently held, the abuse inquiry is purposive and results-oriented. Surely it is not the form of an avoidance transaction that matters: a transaction that is legally valid is subject to the abuse analysis only when it lacks a primary economic or bona fide non-tax purpose in the first place.

Under a unified purposive approach, the purpose and effect of a taxpayer's transaction and the relevant statutory provisions are established by looking beyond[63] the mere wording of the law or the documentation of the transactions. This is important because, in an abuse analysis, the ultimate question is whether the intended purpose or effect of Parliament is defeated by the otherwise legally valid avoidance transaction. As explained below, because Parliament expressed different purposes

62 *Canada Trustco*, supra note 5, at paragraph 44 (SCC).

63 *Copthorne*, supra note 13, at paragraph 47.

through the use of different types of provisions, the typology and organic nature of a specific provision are important in the exercise of statutory interpretation.

ORGANIC INTERPRETATION OF STATUTORY PROVISIONS DESIGNED TO ACHIEVE ECONOMIC ENDS

The Act uses legal concepts to achieve economic ends.[64] It contains over 1 million words and hundreds of provisions arranged in a particular manner to collectively achieve Parliament's intended purposes. It can be viewed as a "paradigmatic system of rules."[65] Because most of the provisions were drafted during a period when the Act received a largely literal interpretation, many provisions were drafted in a highly technical and detailed manner to ensure that the legislative purpose was captured in the text. This drafting style and level of detail and specificity (and complexity), although justified by the nature of the tasks that the Act is expected to perform, makes deciphering legislative purpose a daunting task. This task might be made less daunting by getting to the root of the legislative scheme through an organic approach.

Organically speaking, sections 2 to 4 of the Act are the roots of the basic income tax system in part I of the Act. Since 1972, the "tree" of income, within this system, has two major trunks: income from a source (paragraph 3(a)) and capital gains (paragraph 3(b)). Each trunk has generated branches and stems in the provisions of the Act, some of which are crossovers (such as provisions dealing with depreciable property: the capital cost is recognized in computing income under paragraph 3(a), but any increase in value is recognized under paragraph 3(b)). Although most of these provisions are designed to measure annual income for each taxpayer, some are designed to reduce or exempt income as tax expenditures. SAARs are scattered through the Act as defensive mechanisms to protect the integrity of the income tax system. As demonstrated in *Copthorne*, *Triad Gestco*, and *Global Equity*, it is important to identify the organic scheme that underlies the specific provisions allegedly abused and to appreciate their type and role in the scheme.

Revenue-raising provisions are the raison d'être of the Act; their general purpose is to raise revenue to meet the costs of government. They are facilitated or supported by some technical relief rules, such as the rules relating to timing (rollover rules, deferral rules, loss carryovers, and deemed dispositions). The general purpose of these technical rules is to address concerns about the lack of connection between a taxpayer's economic income and income as computed under the basic rules of the Act on a per-person, per-year, and per-source basis. For example, the rollover

64 Judith Freedman, "Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament" (2007) 123:1 *Law Quarterly Review* 53-90, at 54. See also Alice Abreu and Richard Greenstein, "Tax: Different, Not Exceptional" (2019) 71:4 *Administrative Law Review* 663-717, at 674-79.

65 David A. Weisbach, "Formalism in the Tax Law" (1999) 66:3 *University of Chicago Law Review* 860-86, at 860.

rule under section 73, for transfers of property between spouses, recognizes the reality that the two parties form one economic unit and that any gains or losses accrued with respect to the property are realized on disposition by the unit. The overall objective of revenue-raising provisions is to measure an individual's income as closely as possible in terms of the economic ability to pay.

Tax-incentive provisions share the purpose of encouraging taxpayers to conduct certain economic activities, such as purchasing an owner-occupied home, saving through a registered retirement savings plan (RRSP) or tax-free savings account, and subsidizing certain sectors of the economy. Also embedded in the Act are some "negative tax" rules, such as the Canada child benefit and the refundable goods and services tax/harmonized sales tax (GST/HST) tax credit. Their purpose is to provide means-tested income support to lower-income families; the Act is used by Parliament simply to deliver these supports. These provisions have nothing to do with raising revenue or forgiving taxes as a tax incentive.

SAARs all have the purpose of preventing specific types of tax-avoidance structures or transactions that could be contemplated or foreseen by the drafters; they backstop the application of the revenue-raising and tax-incentive provisions referred to above. As further discussed below, a SAAR can provide clues for discerning the purpose of a provision whose application a targeted transaction is designed to avoid.

The GAAR is a different type of provision. It is not self-executing, and it is superimposed on other provisions. It is also one-sided, in that only the minister can invoke it. Its purpose is to ensure that the purpose of other provisions is not abused.

Revenue-Raising Provisions and the Expectation of Economic Substance

Income as an Economic Concept

The goal of revenue-raising provisions is to determine the amount of tax payable by taxpayers. An income tax is ultimately a tax levied on individuals according to their economic well-being or ability to pay.[66] Because the amount of tax reduces the taxpayer's economic power to consume or save, taxpayers seek to use legal means to minimize it.

The Act does not define "income." Section 3 provides rules for determining income: for example, income must come from a source; taxable capital gains are treated as income; and annual income is a net concept because current-year losses are deductible. As self-operating legal rules for a self-assessment system, these rules

66 Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938), at 59-80; and Carter report, supra note 19. For a recent analysis, see John R. Brooks, "The Definitions of Income" (2018) 71:2 *Tax Law Review* 253-309.

capture the economic income of taxpayers earned in the broadest possible range of common situations. They are supported by detailed rules, in division B of part I of the Act, for determining income from an office or employment,[67] from a business or property,[68] from capital gains, and from "other" sources.

The economic nature of income is evidenced by the wording of subsection 3(1) of the 1917 IWTA, which was "largely taken from the US Revenue Act of 1913";[69] it is the total of income from separate sources, such as "net annual profit or gain or gratuity" as well as "wages, salary, or other fixed amount" and "interest, dividends or profits from money." These amounts are captured by paragraph 3(a). Capital gains became taxable in 1972 under paragraph 3(b). Other provisions in the Act buttress the economic nature of income.[70] As the Federal Court of Appeal held in *Triad Gestco* and *Global Equity*, the language used in section 3 reflects economic income.

Economic Income Prescribed by Legal Rules

The economic concept of income is articulated through rules that fit into the overall inner workings and practical exigencies of the Act as a whole. For this purpose, the Act draws on private law as well as on accepted accounting and business practices. This "marriage of tax to economics" and the desire to provide certainty and predictability have produced a normative preference for rules that create a "crisp blueprint" for economic income.[71] Some of these rules are drafted like formulas and are highly prescriptive. Some basic rules use general legal concepts, such as "person" or "property," to determine tax consequences (for example, taxing each corporation as a taxpayer separate from its ultimate individual owners), while other rules (typically SAARs) look through corporate personality or formal ownership of property in order to properly determine which individual bears the burden of progressive taxation.[72] Ultimately, the Act uses legal concepts to achieve economic ends. From a practical point of view, these rules produce a final amount of tax owed by a taxpayer.

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67 For example, sections 6 and 7 include fringe benefits and employee stock options in computing income from an office or employment, and both provisions emphasize the economic value of the benefit.

68 Even though section 3 does not define income, its supporting rules, such as section 9, do. Moreover, the notion of income is elaborated in cases such as *Canderel*, supra note 55; *Ikea Ltd. v. Canada*, [1998] 1 SCR 196; and *Toronto College Park Ltd. v. Canada*, [1998] 1 SCR 183, where it is stated that accounting principles and business practices are relevant in determining income from a business.

69 Campbell and Raizenne, supra note 16, at 2:22-23.

70 For example, under section 6, any economic benefit derived by employees from their employment is income.

71 See Abreu and Greenstein, supra note 64, at 690.

72 See the discussion of SAARs below, under the heading "SAARs and Targeted Economic Activity."

A holistic and organic approach to purposive interpretation can help reveal the underlying object and purpose of a specific provision of the Act. The decisions in *Triad Gestco*, *Global Equity*, and *Pièces automobiles Lecavalier* provide examples of such an approach. In *Pièces automobiles Lecavalier*, for example, the debt-forgiveness rule in section 80 was interpreted to reflect an increase in the economic power of the debtor when the debt was cancelled.[73]

The Economic Substance of Transactions

In general, the basic revenue-raising provisions are intended to apply to common or normal transactions in order to achieve the economic purposes of the Act. These provisions are buttressed by rules, including SAARs, that function as standards that require transactions to reflect fair market value (FMV) or price and a reasonable businessperson's perspective.

Income and loss are two sides of the same economic coin, and therefore, given that the Act does not tax artificial income, it is logical to expect that the Act does not recognize artificial losses or transactions designed to produce artificial losses.

Transactions that lack economic substance are not intended to be subject to basic revenue-raising provisions and are prima facie abusive. This conclusion finds support in cases dealing with subsection 20(16) (*Duncan* and *Landrus*);[74] with subsection 96(1) (*Mathew*, *MacKay*, *594710 British Columbia Ltd.*, and *Oxford Properties*);[75] and with section 3 (*Triad Gestco*, *1207192 Ontario Ltd.*, *Global Equity*, and *Barrasso*).[76]

Tax-Incentive Provisions and Targeted Economic Activity

Tax-incentive provisions are intended to promote social or economic objectives unrelated to the usual raising of revenue. They result in the promotion of economic goals: a sum of money, delivered through the tax system, nudges taxpayers to do something that has a societal benefit. The transfer of money that occurs through the waiving of the tax otherwise payable is real, not fictional.

Typically, the intended activity is prescribed in the Act. The purpose of tax-incentive provisions may be more directly discernible from their wording than is the case with revenue-raising provisions. Examples of such provisions include the principal-residence exemption and deductions for RRSP contributions.

To date, no GAAR case has found that a tax-incentive provision has been abused. Although the motivation for some surplus-stripping transactions, in cases such as

73 *Pièces automobiles Lecavalier*, supra note 44, at paragraphs 92 and 93.

74 *Duncan*, sub nom. *Water's Edge Village Estates (Phase II) Ltd. v. Canada*, 2002 FCA 291; and *Landrus*, supra note 43.

75 *MacKay v. Canada*, 2008 FCA 105; *Canada v. Oxford Properties Group Inc.*, 2018 FCA 30.

76 *Barrasso v. The Queen*, 2014 TCC 156.

McNichol,[77] was to take advantage of the lifetime capital gains exemption, section 110.6 was not the provision that was found to have been abused.

SAARs and Targeted Economic Effect

The Roles and Types of SAARs

Unlike revenue-raising provisions or tax-incentive provisions that help measure income or give away otherwise taxable income, SAARs function as proverbial antibodies that protect the intended purpose and effect of substantive provisions.[78] They do not create new "terrain" or new rules.[79] If the GAAR is a searchlight with respect to the Act's deeper purposes, SAARs function as personal flashlights that illuminate the specific path for discerning the legislative purpose embedded in the words of the provisions of a statutory scheme.

Since legislative purpose is frequently not apparent from the bare words of a specific provision, a SAAR may offer clues regarding the purpose of the legislative scheme or basic provision that it seeks to protect. Examples include the anti-surplus-stripping purpose revealed by section 84.1 and the anti-loss-trading purpose of subsection 111(5). Of greater relevance to this chapter is the fact that some SAARs implicitly require transactions to have economic substance by (1) referring to FMV or price (for example, sections 69 and 247); (2) imposing a reasonableness standard (for example, section 67); or (3) requiring transactions that give rise to creditable foreign income taxes to be reasonably expected to realize an economic profit (for example, subsection 126(4.1)).

The importance of SAARs is evident from their history and ubiquitous presence in the Act. The 1917 IWTA contained several SAARs, including subsection 3(2), which is the original of the current section 247 and subsection 3(4)—which, in turn, are the originals of the regime for integrating the taxation of privately held corporations and their shareholders. It is difficult to find many significant tax regimes in the Act that are not accompanied and supported by SAARs. By identifying uncommon transactions or filling the gaps between basic provisions, SAARs provide certainty and keep the basic provisions "simple."

With respect to drafting style, SAARs can generally be categorized as SAARs-as-standards or SAARs-as-rules. SAARs-as-standards are designed to express general expectations of the Act. SAARs-as-rules are more "surgical," targeting specific types of transactions or results that would otherwise defeat the purpose of basic provisions. SAARs-as-rules draw hard lines around the scope of their application, an

77 Infra note 99.

78 For a discussion of the relationship between SAARs and the GAAR, see Shawn D. Porter, "The Relationship Between the General Anti-Avoidance Rule and Specific Anti-Avoidance Rules," in chapter 17 of this volume.

79 Weisbach, supra note 65, at 868 regards specific rules as finer lines on the map to match the underlying terrain in the topological map.

example being paragraph 95(6)(b), which targets a particular transaction (that is, the acquisition or disposition of shares in a non-resident corporation).[80] SAARs-as-standards, by contrast, draw fuzzy or dotted lines and invite the judiciary to brighten the lines or connect the dots; they are closer in nature to a GAAR.

Economic Substance Implied by SAARs-as-Standards

SAARs-as-standards include sections 67, 69, 247, and former section 245. They generally defer to the market as a benchmark for determining the amount of revenue or expenses for computing income for tax purposes.

The reasonableness standard in section 67 can be traced to subsection 6(2) of the 1932-33 IWTA,[81] which authorized the minister to disallow as an expense the portion of any salary, bonus, or commission exceeding a reasonable amount for the services performed. This rule was expanded in 1940 to any business expense incurred in respect of any transaction or operation that unduly or artificially reduced income.[82] In 1948, the more generally worded subsection 12(2) replaced subsection 6(2):

> In computing income, no deduction shall be made in respect of an outlay or expense otherwise deductible except to the extent that the outlay or expense was reasonable in the circumstances.[83]

Subsection 12(2) became section 67 in the 1972 Act, with minor modifications.[84] The reasonableness standard has been interpreted by the courts to be a "reasonable business person" test according to which "no reasonable business person

80 For an interpretation of this SAAR, see *Lehigh Cement*, supra note 36. In *Landrus*, supra note 43, at paragraph 41, the Federal Court of Appeal stated: "I agree with the appellant that the fact that specific anti-avoidance provisions can be demonstrated not to be applicable to a particular situation does not, in and of itself, indicate that the result was condoned by Parliament. . . . However, where it can be shown that an anti-avoidance provision has been carefully crafted to include some situations and exclude others, it is reasonable to infer that Parliament chose to limit their scope accordingly."

81 Income War Tax Act, SC 1932-33, c. 41 (herein referred to as "the 1932-33 IWTA"), subsection 6(2) read: "The Minister may disallow as an expense the whole or any portion of any salary, bonus, commission or director's fee which in his opinion is in excess of what is reasonable for the services performed."

82 Subsection 6(2) read: "The Minister may disallow any expense which he in his discretion may determine to be in excess of what is reasonable or normal for the business carried on by the taxpayer, or which was incurred in respect of any transaction or operation which in his opinion has unduly or artificially reduced the income."

83 Income Tax Act, SC 1948, c. 52 (herein referred to as "1948 Act"), subsection 12(2).

84 Section 67 of the 1972 Act read: "In computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances."

would have contracted to pay such an amount having only the business considerations of the [taxpayer] in mind."[85] In other words, business reality or normal business practices are relevant.

Sections 69 and 247 impose an FMV or price standard for testing the acceptability of the price of a transaction between non-arm's-length parties.[86] This standard presumes that the market price is the most reliable and observable basis for computing income. Where the price is set for non-market reasons, the effect of that price manipulation for tax purposes is replaced by the FMV standard. This standard originated in subsection 3(2) of the 1917 IWTA.[87]

Former subsection 245(1),[88] which was repealed when the GAAR was enacted, imposes an anti-artificiality standard: artificial deductions could be disregarded in computing income for tax purposes. This standard can be traced back to section 137 of the 1952 Act, and before that to section 125 of the 1948 Act and section 32A of the 1940 IWTA.[89] The notion of "artificiality" refers to the "*nature* of the transaction,"[90] since the *price* of the transaction is already covered by the FMV standard. The concept of an artificial transaction is interpreted by the courts to refer to a "simulated" or "fictitious" transaction[91] or a transaction that is "unnatural" or "not in accordance with normality."[92] "Natural" or "normal" transactions are presumably common transactions that take place in the market, or transactions with economic substance and/or effect.

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85 *Gabco Ltd. v. MNR*, 68 DTC 5210 (Ex. Ct.), at paragraph 52.

86 FMV is interpreted as "the highest price an asset might reasonably be expected to bring if sold by the owner in the normal method applicable to the asset in question in the ordinary course of business in a market not exposed to any undue stresses and composed of willing buyers and sellers dealing at arm's length and under no compulsion to buy or sell"; see *Henderson v. MNR*, [1973] CTC 636 (FCTD), at 644.

87 Subsection 3(2) of the 1917 IWTA became section 23 of the 1927 IWTA, and then became section 16 of the 1943-44 IWTA. In 1948, section 17 was introduced to provide more details regarding cross-border purchase and sale transactions and in-kind corporate distributions. This provision became section 18 of the 1952 Act and subsections 69(2) and (3) of the 1972 Act. Section 69 extended the FMV standard to dispositions of property to facilitate the newly introduced capital gains tax regime. In 1998, section 247 was enacted to replace subsections 69(2) and (3).

88 Former subsection 245(1) read: "In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or an expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce income."

89 Subsection 32A(1) of the 1940 IWTA stated: "Notwithstanding any of the provisions of this Act, the Treasury Board may in its discretion determine that any transaction has artificially reduced or would artificially reduce taxation and has no reasonable business purpose other than that of avoiding or minimizing taxation hereunder and that no deduction shall be allowed with respect to any expense or disbursement resulting there-from."

90 Dodge, supra note 3, at 6 (emphasis added).

91 *Spur Oil Ltd. v. The Queen*, 81 DTC 5168 (FCA).

92 *Consolidated-Bathurst Limited v. The Queen*, 87 DTC 5001 (FCA).

Effect-Over-Form Under SAARs-as-Rules

SAARs-as-rules include provisions that address specific types of tax-planning structures that are designed to achieve, among other aims, tax arbitrage, income or loss shifting, the transformation of a transaction's character, the manipulation of timing, and the manipulation of tax attributes. Examples of such SAARs and the "hinted-at" legislative purpose of the underlying substantive provisions or schemes include

- *Anti-tax-arbitrage rules*. Examples include section 20.3,[93] which reflects paragraph 20(1)(c)'s purpose of limiting interest deductions to money borrowed to earn income from a business or property, as opposed to capital gains; section 56.4,[94] which reflects the broad purpose of "source" in section 3 and distinguishes between capital gains and income from a source; and regulation 1100(1.1),[95] dealing with specified leasing property, which reflects the CCA regime's purpose of allowing deductions to owners and users of depreciable property, but not to lessors who function as lenders.
- *Anti-shifting rules*. Examples include subsection 56(2) (indirect payments), sections 74.1 and 74.2 (attribution rules), and section 124.1 (tax on split income rules), which reflect the Act's purpose (especially subsections 2(1) and 117(2)) of imposing progressive taxation on an individual basis and of treating as the taxpayer the person who has earned the income; subsection 111(5), which reflects the purpose of computing the taxpayer's taxable income (on a multi-year basis) in respect of the business activity of that taxpayer (that is, a policy against corporate loss-trading); and paragraph 85(1)(e.2), which reflects the purpose of anti-shifting through value-shifting in the course of a rollover. The first anti-shifting rule was subsection 4(4) of the 1917 IWTA, which recognized the validity of gifts between spouses, but attributed the income from the gifted property to the transferor.[96]
- *Anti-timing-manipulation rules*. Examples include subparagraph 40(2)(g)(i), which reflects the purpose of recognizing losses on the actual (not paper)

93 Introduced in response to the tax-arbitrage transactions known as "weak-currency loans," approved in *Shell Canada Ltd. v. Canada*, [1999] 3 SCR 622.

94 Introduced in response to cases such as *Fortino et al. v. The Queen*, 2000 DTC 6060 (FCA); and *Manrell v. Canada*, 2003 FCA 128.

95 Introduced in 1989; see Israel Mida and Kathleen Stewart, "The Capital Cost Allowance System" (1995) 43:5 *Canadian Tax Journal* 1245-64, at 1257.

96 Subsection 4(4) of 1917 IWTA read: "A person who, after the first day of August, 1917, has reduced his income by the transfer or assignment of any real or personal, movable or immovable property, to such person's wife or husband, as the case may be, or to any member of the family of such person, shall, nevertheless, be liable to be taxed as if such transfer or assignment had not been made, unless the Minister is satisfied that such transfer or assignment was not made for the purpose of evading the taxes imposed under this Act or any part thereof."

disposition of property; and subsection 18(13), which reflects the purpose of not recognizing income or capital gain where property is disposed of but remains within the same economic unit.

- *Anti-character-transformation rules*. Examples include subsections 212(3.6) and (3.7), which treat interest as dividends or royalties for withholding tax purposes; paragraph 258(3)(a), which deems dividends on term-preferred shares to be interest; and sections 84.1 and 212.1, which reflect the purpose of taxing distributions of corporate after-tax profit as dividends as opposed to taxing them as capital gains or returns of capital (surplus-stripping rules). The earliest surplus-stripping rule was likely subsection 3(9) of the 1924 IWTA, which deemed a distribution of property to be the payment of a dividend to the extent that the company had undistributed income. Recent regimes specifically aimed at character-transformation arrangements, such as back-to-back arrangements to convert the character of payments, were introduced to address "synthetic" arrangements.
- *Lookthrough legal-fiction rules.* Examples include section 91, which imputes foreign accrual property income earned by a controlled foreign affiliate to the resident shareholders for tax purposes, reflecting the Act's purpose of taxing resident taxpayers on their economic income irrespective of the "legal separation" of such income from the taxpayers through legal intermediation (such as the use of a foreign corporation); subsections 125(2) and (3), which limit the benefit of the small business deduction to a group of associated corporations, thus reflecting the Act's purpose of treating a corporate group as an economic unit for this purpose; and section 186, which imposes a refundable tax on dividends received by private corporations, reflecting the purpose of treating a private corporation and its shareholders as a fiscal unit for the purpose of imposing progressive taxation on personal income.[97] The earliest lookthrough rule was subsection 3(4) of the 1917 IWTA, which imputed the distributed income of a corporation (as well as any syndicate, trust, association, or partnership) to the individual owner for the purpose of the super-tax, unless the retained profit was "not in excess of what is reasonably required for the purposes of the business."
- *Substance-over-form rules.* Examples include paragraph 12(1)(g), which treats amounts paid for the use of or production from property as rent or royalties

97 For more on the concept of fiscal unity, see J. Scott Wilkie, "Three Spirits of Canadian Corporate Income Tax: The Relic, the Remnant, and the Reflection," in *Income Tax at 100 Years*, supra note 15, 8:1-32. The idea that some SAARs function as "bridges" between the notion of the rule of law (including the right of taxpayers to take advantage of legislative ambiguities and deference to legal fictions) and the idea that the Act measures the economic income of an economic unit (such as members of a corporate group) was inspired by a student paper: Jenna Clark, "Bridges over Troubled Waters: Legislative and Judicial Links Between the Legal Form of the Corporation and the Economic Reality of the Corporate Group" (on file with the author).

even if the form of the transaction is a sale; subsection 16(1), which treats a sale transaction as having an embedded lending transaction; and subsection 18(4), which denies the deduction of interest on non-resident shareholder loans that exceed the specified debt-to-equity ratio and treats the excessive interest as dividends. These rules have a long history. For example, paragraph 12(1)(g) can be traced to paragraph 3(f) of the 1934 IWTA, and subsection 16(1) goes back to subsection 3(2) of the 1942-43 IWTA.

SAARs tend to target uncommon transactions so that these transactions do not become common transactions that fall within the scope of the basic provisions. For example, sale and leaseback transactions in the nature of financing are not treated as common purchase and sale transactions subject to the CCA scheme.[98] The purpose of a SAAR is to ensure that the intended purpose or effect of the "protected" basic provisions is not frustrated by uncommon transactions.

The Role of SAARs in GAAR Cases

Close to half of the GAAR cases listed in the appendix to this chapter, including three Supreme Court decisions, involve the abuse of a SAAR. The abuse is shown by the avoidance transaction's circumventing the application of the SAAR (for example, *Copthorne*) or turning the SAAR on its head (for example, *Mathew* and *Lipson*). The common thread in these cases is that, in the absence of the GAAR, the targeted effect of a SAAR would be neutralized by the avoidance transaction.

In the GAAR cases involving a SAAR, the courts focused on the effect of these transactions. One group of such cases deals with surplus-stripping transactions that are designed to convert pre-taxed corporate income into capital or capital gains. These cases include *McNichol*, *RMM*, *Nadeau*, *Desmarais*, *Descarries*, and *Pomerleau.*[99] *Copthorne* may not be viewed as a typical surplus-stripping case, but it effectively is one. In *Copthorne*, Rothstein J stated that the amounts that may be extracted by shareholders from a corporation without tax are limited to the PUC, which represents after-tax income or tax-paid funds.[100] Pre-tax funds identified by sections 84.1 and 212.1 and by the parenthesis in subsection 87(3) must reduce the PUC of shares under subsection 89(1) to prevent such funds from being treated as tax-free capital.[101] In these cases, the result of the avoidance transactions was found to be abusive because the transactions defeated the purpose of these

98 Canada, Department of Finance, 1976 Budget, Budget Paper C, May 25, 1976, at 25. See also Mida and Stewart, supra note 95, at 1257.

99 *McNichol et al. v. The Queen*, 97 DTC 111 (TCC); *RMM Canadian Enterprises Inc. et al. v. The Queen*, 97 DTC 302 (TCC); *Nadeau v. The Queen*, 99 DTC 324 (TCC); *Desmarais v. The Queen*, 2006 TCC 44; *Descarries v. The Queen*, 2014 TCC 75; *Pomerleau v. Canada*, 2018 FCA 129.

100 *Copthorne*, supra note 13, at paragraph 95.

101 *Pomerleau*, supra note 99, at paragraph 64; *Copthorne*, supra note 13, at paragraphs 93-96.

rules. More fundamentally, once income is earned by a corporation (on behalf of its shareholders), it should be taxed as income in the hands of the shareholder, and the corporate fiction or legal arrangements should not be used to turn taxable income into tax-free capital.

Another group of GAAR cases involving SAARs dealt with loss-limitation rules (for example, subsection 18(13)) and anti-income-shifting rules (such as sections 74.1 and 74.2, and subsection 75(2)). These rules are intended to prevent the shifting of losses or income between members of the same economic unit but were used to shift income in *Mathew*, *MacKay*, *Lipson*, and *Fiducie financière Satoma*.[102] For example, in *Mathew*, the Supreme Court considered the "combined effect of the partnership rules and subsection 18(13)—to disallow taxpayers to preserve and transfer unrealized losses to arm's length parties"[103]—and found that the effect of the avoidance transactions contradicted that intended effect. In *Lipson*, LeBel J considered the overall result of the series of transactions that included an avoidance transaction—(1) the deduction of the interest payments on a mortgage, (2) the effect of subsection 73(1) to "facilitate interspousal transfers of property without triggering immediate tax consequences,"[104] and (3) the purpose of subsection 74.1(1))—and he found that section 74.1 was intended to prevent spouses from reducing tax by taking advantage of their non-arm's-length relationship with respect to interspousal transfers of property. Thus, section 74.1 was intended to prevent the effect of the avoidance transactions.

Revisiting Canada Trustco: An Example of Considering Economic Substance Through Organic Interpretation

Recap

Below, on the basis of the recent developments in the GAAR jurisprudence and Parliament's intention in enacting section 245, this chapter makes the case for giving economic substance an enhanced role in the abuse analysis through a rigorous, disciplined, and organic interpretation of statutory provisions and a unified approach to construing both the law and the facts. To illustrate how the proposed approach might be applied, I consider the *Canada Trustco* case.[105]

Canada Trustco Mortgage Co. (CTMC) carried on business as a mortgage lender. In 1996, CTMC entered into an arrangement that included the following steps:

- CTMC took a non-recourse loan of Cdn$97.35 million from the Royal Bank of Canada (RBC) at an interest rate of 7.5 percent.

102 *Fiducie financière Satoma v. Canada*, 2018 FCA 74.

103 *Mathew*, supra note 22, at paragraph 37.

104 *Lipson*, supra note 23, at paragraph 31.

105 This part of the chapter has benefited tremendously from the insights of Scott Wilkie, with respect to both the transactions and the statutory provisions.

- CTMC used the borrowed money, together with some of its own funds, to purchase trailers from TLI (a US resident) for Cdn$120 million.
- CTMC then leased the trailers to MAIL (a UK-resident company) at the rate of 8.5 percent, with an option to purchase.
- MAIL subleased the trailers to TLI.
- TLI prepaid all amounts due to MAIL (that is, Cdn$116.4 million) under the sublease.
- MAIL deposited Cdn$97.35 million with RBC (defeasance arrangement) and paid about Cdn$19 million to RBC Jersey, as trustee, with a pledge that the bond purchased with the Cdn$19 million would be used as security for MAIL's obligations to pay rent.
- CTMC assigned its rental payments to RBC as payments under the loan.

For tax purposes, CTMC claimed CCA of $31 million with respect to the trailers against rental income of Cdn$36 million in 1996, and it claimed CCA of Cdn$46 million against Cdn$51 million of rental income in 1997. When the interest deduction was considered, CTMC had a loss from the arrangement and that loss was used to offset income from other sources. The issue was whether the CCA deductions should be denied under the GAAR.

Thirteen judges in the Tax Court, Federal Court of Appeal, and the Supreme Court agreed that the GAAR did not apply in this case. The decisions do not single out any specific transaction as an avoidance transaction or any specific provision of the Act that was abused. Instead, all of the transactions in the arrangement or series seem to have been treated as avoidance transactions, and the CCA provisions were interpreted and found not to have been abused by the transactions.

Economic Substance of the Transactions

Do the transactions in *Canada Trustco* have economic substance? First, since the *Canada Trustco* decision in 2005, the Supreme Court has clarified in *Lipson* and *Copthorne* that a specific transaction needs to be identified as an avoidance transaction. Such a transaction may result in a tax benefit on its own or as part of a series of transactions that results in a tax benefit. The purpose test is applied to the specific transaction, not to the series. As shown by Miller J's finding in *Canada Trustco*, an investment that is commercially profitable overall does not preclude one step in the arrangement from being an avoidance transaction. In other words, no dichotomy exists between an overall economic purpose of a series of transactions and a primary tax-avoidance purpose of a specific transaction in the series. Assuming that one or more transactions (such as the lease, sub-lease, and pre-payment) are the pinpointed transactions, it would be easy to conclude that no primary economic purpose exists for such transactions.

As this case shows, real commercial transactions often have an economic purpose as well as a tax purpose. With respect to sale-leaseback transactions, Miller J found that the tax treatment is "not extraneous to the commercial venture, but intrinsic to it."[106] Thus, it is critical to weigh the evidence objectively to discern whether obtaining the tax benefit was the primary purpose; if, as in this case, the tax benefits were the primary reason for CTMC to enter into the arrangement, the purpose test is met.

What about the economic result of the avoidance transactions? Apart from the tax savings, how was CTMC's economic position changed by these transactions? CTMC invested about Cdn$23 million of its own funds (plus transaction costs) in this arrangement; its rental income more or less offset the cost of the loan from RBC, and the loan was a non-recourse loan covered by a debt defeasance with prepayment from TLI. The Cdn$23 million investment was more than recovered from the CCA deduction in 1996 alone. No evidence suggests that the real source of profit was something other than the tax deductions.

In effect, the arrangement is not like an ordinary sale-leaseback transaction that enables the lessor and lessee to share the benefit of CCA and interest deductions and thus lowers the cost of financing the acquisition of business assets. An ordinary sale-leaseback would have involved CTMC purchasing the trailers from a trucking company or from a company whose principal business was leasing and then leasing the trailers back to that company. The transactions in *Canada Trustco* were not ordinary sale-leaseback transactions because of the TLI prepayment, the debt defeasance, the RBC non-recourse financing, TLI as a non-resident corporation, and the circuitous nature of the arrangement. The defeasance of CTMC's purchase obligation was pre-arranged to ensure that CTMC would not have to use its own funds to pay for the trailers. Because most of the purchase price was, by design, recycled to CTMC from the outset, the Cdn$120 million cost that was claimed to be the basis for the CCA deductions was for the most part fictitious.

The effect of the transactions, for tax purposes, was that CTMC "unlocked" the value of CCA deductions that were not available even to TLI, the original owner and actual user of the trailers, because TLI was not a taxpayer resident or carrying on business in Canada. The effect was the same as the result sought by the taxpayer in *Duncan*[107]—claiming CCA deductions in respect of a foreign capital cost. In *Duncan*, the historical cost of a computer in the United States was "imported" into the Canadian tax system for CCA purposes, and that result was found to be abusive. In *Canada Trustco*, the Cdn$120 million FMV of TLI's trailers used by TLI in its ordinary leasing business became the basis for CTMC's CCA deductions.

An Organic Interpretation of the Statutory Scheme for CCA

In *Canada Trustco*, without identifying any specific CCA provisions other than paragraph 20(1)(a), the courts construed the CCA provisions as a whole and focused on the meaning of "cost." A more rigorous construction, under the organic

106 *Canada Trustco*, supra note 5, at paragraph 53 (TCC).

107 *Duncan*, supra note 74.

approach proposed in this chapter, would have identified (1) a specific provision relied on by the taxpayer in obtaining the tax benefit, (2) the CCA scheme, and (3) the type of provisions in the scheme, and it would have situated this scheme in the broader context of computing income from a business or property.

The CCA scheme comprises (1) a basic provision, (2) supporting technical rules, (3) SAARs, and (4) tax incentives, which are arranged in the following hierarchy:

1) A basic rule: paragraph 20(1)(a) allows a deduction for a portion of the cost of depreciable property owned by a taxpayer in computing profit, and it overrides the prohibition on the deduction of capital expenditures in paragraph 18(1)(b).
2) Supporting rules:
    a) Regulations 1100(1) and 1100(2) specify details for determining the maximum amount of CCA deductible each year on a class basis.
    b) Subsections 13(21) and 248(1) and section 54 define relevant terms used in the rules.
    c) Subsections 13(1) and 20(16) reconcile the amount of actual loss in the value of the property and the CCA deductions claimed in previous years.
3) SAARs, including:
    a) Sections 67 and 247, to whose reasonableness standard the amount of the "cost" is subject.
    b) Regulation 1100(11), regarding rental property (limiting CCA deductions to the rental income derived by a taxpayer so that CCA deductions do not become tax shelters).
    c) Regulations 1100(15) to (19), regarding leasing property (limiting the total CCA deductions to the total leasing income derived by a taxpayer).
    d) Regulation 1100(1.1), regarding specified leasing property (limiting CCA deductions to the amount that would have been a repayment of principal had the lease been a loan and had the lease payments been blended payments of principal and interest; the notional principal repayment is determined by first calculating the notional interest under regulation 4302).[108]

108 The lessor is entitled to deduct CCA measured with reference to the principal portion of a Canada bond, and otherwise includes the full amount of the rental payments (both the capital and interest components), reducing its income by a capital amount meant to replicate the repayment of the principal amount of borrowed money. Because the lessee pays and deducts rent, the result is more or less in balance: the lessee is treated as having financed the acquisition of an asset that it "owns" and that depreciates, and the lessor is treated as a lender of borrowed money. An election under section 16.1 is available to the lessee to deduct CCA and interest instead of the lease payments.

4) Tax incentives, such as the following:
   a) A rate of 100 percent for CCA with respect to zero-emission vehicles (class 54 and class 55).
   b) Regulation 1100(1.13) excludes "exempt property" from the specified leasing property rule in regulation 1100(1.1); trailers and light trucks are included in the list of exempt property.

The CCA scheme is part of the system used for computing income from business or property under section 9. Section 9, in turn, supports the application of section 3, which in turn supports the charging rule in section 2.

What is the purpose and rationale of the CCA scheme? Noël J captured the essential purpose of the CCA scheme in *Duncan*:

> [T]he capital cost allowance system is intended to recognize over time costs incurred to acquire capital assets actually used to earn income within the meaning of paragraph 18(1)(a) and (b), and . . . the "recapture" and "terminal loss" provisions are intended to adjust the aggregate deduction so recognized when subsequent events demonstrate that the asset has been over or under depreciated.
>
> There can be no doubt that the object and spirit of the relevant provisions 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 under the Act.[109]

By using expressions such as assets "actually used to earn income" and "consumed in the income earning process," Noël J conveyed a sense of the business reality found in a typical situation where an owner of assets is also the user of the assets in the process of earning income.

Within the CCA scheme, there is a subsidiary scheme for sale-leaseback transactions. In *Canada Trustco*, the Supreme Court refers to this subsidiary scheme without much elaboration.[110] Sale-leaseback transactions are subject to SAARs because, in effect, they transfer CCA deductions from the lessee/user to the lessor/owner. This type of transfer of a tax attribute occurs where the CCA deductions are not valuable to the user (for example, where the user is in a loss position or is a tax-exempt entity). The leasing property rules specified in regulation 1100(1.1) effectively deny the CCA deduction to the lessor/owner and treat the lessor/owner as a lender.

The "exempt property" rules in regulation 1100(1.13) are in the nature of tax incentives and were critical to the design of the tax arrangement in *Canada Trustco*. In this case, trailers were acquired by CTMC because they are exempt from the SAARs applicable to specified leasing property. What is the purpose and rationale of this tax incentive? What is the targeted activity to be subsidized? Historical context provides some clues.

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109 *Duncan*, supra note 74, at paragraphs 41 and 44.

110 *Canada Trustco*, supra note 5, at paragraph 74 (SCC).

- On June 6, 1988, the minister of finance, with the agreement of the minister's provincial and territorial counterparts, announced in a news release (no. 88-69) a moratorium on the practice of sale and leaseback transactions by tax-exempt entities. Previously, it had become common for tax-exempt entities to sell their property to taxable entities and then immediately lease the property back. Tax deductions that would not have been available to the tax-exempt entity, such as CCA, were then claimed by the taxable lessor, even though the lessee retained possession and use of the property.[111]
- On April 27, 1989, the federal budget and the notice of ways and means motion announced measures to address sale and leaseback transactions without any exception for trucks and trailers.[112]
- Representations by the Canadian Truck Renting and Leasing Association and Canadian Truck Equipment Association during the consideration of the bill by the House of Commons sought an exemption from the proposed rules in order to save Canadian jobs in the trucking industry: in their view, the proposed rules would drive customers to obtain equipment from US sources and would make the Canadian trucking industry less competitive.[113]
- Officials from the Department of Finance met with representatives of the trucking industry and reported to the House of Commons on December 15, 1989 that the proposed rules would be redrafted to alleviate the negative impact on small businesses.[114]
- On February 2, 1990, the Department of Finance released draft income tax regulations to include exemptions for trucks and trailers.[115]

This summary of the legislative history suggests that the purpose of exempting trailers from the specified leasing property rules was to subsidize Canadian businesses and save Canadian jobs.

Considering Economic Substance in the Abuse Analysis

Can it be said that economic substance—in terms of an economic purpose or an economic result—is intended by the CCA scheme in general, and by the SAARs and tax-incentive provisions in particular?

First, the CCA scheme is part of the system for determining profit or loss under section 9 of the Act. Profit and loss are economic outcomes measured by legal concepts that refer to widely accepted business and accounting principles (as noted

111 Millie Goodman and Deborah L. Ort, "Checklist" (1988) 36:3 *Canadian Tax Journal* 769-824.

112 Canada, Department of Finance, 1989 Budget, Budget Papers, April 27, 1989 (www.budget.gc.ca/pdfarch/1989-pap-eng.pdf).

113 Bill C-28: first reading on October 11, 1989 and second reading on November 23, 1989.

114 Canada, House of Commons, *Debates*, December 15, 1989, at 6970.

115 "Revised Draft Regulations on Leasing Released" (1990) 24 *CGA Magazine*, at 6.

in, for example, *Canderel* and *Global Equity*). The SAARs-as-standards in sections 67, 69, and 247 reinforce this point. Therefore, transactions that give rise to CCA deductions should be expected to have economic substance. In *Duncan*, the Federal Court of Appeal stated that subsection 20(16) reflects a real economic loss and that CCA deductions and terminal loss deductions are intended to match "the actual cost of the depreciable property to the taxpayer."[116] In *Landrus*, the terminal loss was recognized because the legal arrangements that gave rise to the loss brought about material changes, both in terms of risks and benefits.[117]

The SAAR with respect to specified leasing property targets financial leases and denies the lessor/lender the tax treatment designed for an owner or user of depreciable property. It effectively substitutes the tax consequences of a lending transaction for those of a financial lease because the economic results of a financial lease are the same as those of a lending transaction.

In entering into the transactions, CTMC relied on the tax incentive for financial leases of trailers. Assuming that this tax incentive was intended to assist the Canadian trucking industry, the effect of CTMC's transaction was to benefit a foreign taxpayer (TLI) and CTMC, which, as a financial institution, was not engaged in the Canadian trucking industry.

To conclude, a reconsideration of *Canada Trustco* clarifies three main points about the role of economic substance in the abuse analysis under subsection 245(4). First, the legislative purpose and intent of the relevant provision or provisions of the Act should be determined through a disciplined and rigorous process of statutory interpretation, as exemplified by the *Copthorne*, *Triad Gestco*, and *Global Equity* decisions. Using the GAAR to shed light on the underlying purpose and rationale of a provision is not the same as using the GAAR to "make" law. The GAAR is not intended to be a stand-alone substantive rule. In *Canada Trustco*, the GAAR did not empower the courts to "legislate" the meaning of cost by reading in a concept of "economic risk." Instead, the GAAR required the courts to determine the purpose and effect of the CCA provisions. As shown above, these provisions include different types of rules—namely, basic rules, SAARs, and tax incentives, each of which has different, albeit connected, purposes. It is overly simplistic to generalize about all of these provisions in cases where one specific type of provision was relied on by the taxpayer in designing an avoidance transaction.

Second, as with the CCA regime, Parliament uses different types of provisions to achieve specific purposes or effects. The typology of provisions can provide clues to their interpretation. The "task is to discern the meaning of the provision's text using all of the objective clues available to us."[118] Economic substance, understood in terms of a primary non-tax purpose and non-tax result, is contemplated by

116 *Duncan*, supra note 74, at paragraphs 39 and 40.

117 *Landrus*, supra note 43, at paragraph 57.

118 *Lehigh Cement*, supra note 36, at paragraph 44.

Parliament through revenue-raising provisions such as paragraph 20(1)(a), and it is backstopped by SAARs such as the specified leasing property rules. A specific economic effect is generally intended by tax-incentive provisions, such as an exemption for trucks and trailers.

Third, the role of economic substance becomes more clear when the meaning of "avoidance transaction" under subsection 245(3) is considered alongside the meaning of "abuse" under subsection 245(4). Subsection 245(3) explicitly refers to the "purpose" of transactions. The two-step analysis sanctioned by the Supreme Court in determining abuse emphasizes the result or effect of the impugned avoidance transaction. If the effect is artificial (that is, if it is not economically effective or realistic in the real world), such as the inflation of PUC in *Copthorne* or the inflation of CCA in *Duncan*, abuse is evident. Parliament has embedded enough clues in the Act for the courts to determine that the PUC and CCA rules are intended to have real economic effect. Therefore, transactions that seek to take advantage of these rules should be expected to have economic, as opposed to mere paper or fictitious, effects.

Appendix: Typology of Abused Provisions in GAAR Cases

Case	Tax-raising	Tax relief	Tax incentive	SAAR	The Act read as a whole
McNichol et al., 97 DTC 111 (TCC)				84(2), 84.1	
RMM, 97 DTC 302 (TCC)*				84(2), 212.1	
Nadeau, 99 DTC 324 (TCC)				84(3)	
OSFC, 2001 FCA 260					policy against loss trading
Duncan, 2002 FCA 291	20(16)				
Mathew, 2005 SCC 55	96			18(13)	
Desmarais, 2006 TCC 44				84.1	
MacKay, 2008 FCA 105	96			18(13)	
Lipson, 2009 SCC 1				74.1	
Copthorne Holdings Ltd., 2011 SCC 63				87(3)	
Triad Gestco, 2012 FCA 258	3(b), 38(b), 39(1)(b), 40(1)(b), 54				
1207192 Ontario Ltd., 2012 FCA 259	38(b), 39(1)(b), 40(1)(b)				
Global Equity Fund, 2012 FCA 272	3, 4, 9, 111				
Pièces automobiles Lecavalier, 2013 TCC 310	80 to 80.04				
Barrasso, 2014 TCC 156	38(b), 39(1)(b), 40(1)(b)				

(The appendix is concluded on the next page.)

Appendix Concluded

Case	Tax-raising	Tax relief	Tax incentive	SAAR	The Act read as a whole
Descarries, 2014 TCC 75				84.1	
Golini, 2016 TCC 174*	15				
Fiducie financière Satoma, 2018 FCA 74		112(1)		75(2)	
Gervais, 2018 FCA 3	73			74.2	
Oxford Properties, 2018 FCA 30	100(1)				
594710 British Columbia Ltd., 2018 FCA 166	96(1)			103(1), 160	
Pomerleau, 2018 FCA 129				84.1	
2763478 Canada Inc., 2018 FCA 209	3(b), 38(b), 39(1)(b), 40(1)(b)				
Birchcliff, 2019 FCA 151		256(7)(b)(iii)(B)			
Gladwin Realty Corporation 2019 TCC 62	83(2), 40(3)			40(3.1)	

* GAAR as an alternative argument.

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The Determination of the Tax Consequences When the General Anti-Avoidance Rule Applies

*Chris Sprysak**

Introduction

As noted in chapter 5, once the three prerequisites for the application of the general anti-avoidance rule (GAAR) have been established—namely, (1) a "tax benefit" that results from (2) an "avoidance transaction" that (3) misuses or abuses the object, spirit, and purpose of one or more provisions of the Income Tax Act[1]—subsection 245(2) provides that

> the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

For ease of reference, this step is referred to in this chapter as a "GAAR determination."

Subsection 245(1) defines "tax consequences" broadly in relation to the person affected by a GAAR determination: "the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount." Subsection 245(5) provides four examples of possible GAAR determinations that could constitute a reasonable tax consequence:

> Without restricting the generality of subsection (2), and notwithstanding any other enactment,

* Associate professor, Faculty of Law, University of Alberta.

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