TOWARDS INTEGRITY IN TAX LAW: THE PROBLEM OF FORM AND SUBSTANCE IN CANADIAN TAX JURISPRUDENCE.

by

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Abstract

This study examines the problem of form and substance in Canadian tax jurisprudence, which has been characterized by a troubling equivocation between formalistic and substantive approaches in cases involving tax avoidance transactions with the current period of jurisprudence dominated by formalism. The vacillation of Canadian jurisprudence contrasts with the consistently substantive tax jurisprudence of the United States. The latter situation discloses an unresolved doctrinal tension in Canadian tax jurisprudence between two viable doctrinal alternatives. This study seeks to resolve the problem of form and substance by finding the right answer to the problem by examining the tax policy, political, and legal philosophical implications of formalistic jurisprudence along with the manner in which the legal system as a whole (i.e. jurisprudence outside of tax law) rationally employs both form and substance for distinct purposes to solve distinct kinds of legal problems. Using the principles that are implied in the practices of the legal system as a whole, a right answer to the form and substance problem – one that is horizontally consistent or integral with the whole – suggest itself, namely that substantive, judge-made standards are the right solution to the problem of form and substance in Canadian tax jurisprudence and that formalism in tax jurisprudence is a legal aberration in the Canadian legal system.
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Dedication

For Mini.
1. Introduction

The scope of the problem of tax avoidance is difficult to determine and I have not found any Canadian literature that attempts to estimate it. Moreover, the problem is inherently difficult to estimate because most tax avoidance schemes (or “tax shelters” as they are sometimes called) are hidden. However, it is estimated that tax shelters reduced tax revenues in the United States by approximately $10 to $24 billion in 1999.1 Comparing reported income for tax and financial purposes, Mihir A. Desai found a difference of approximately $154.4 billion between corporate income reported for tax purposes and book income reported on financial statements which could not be explained.2 In Canada, tax avoidance transactions are possible because tax law permits taxpayers to enter into transactions that have no economic substance but the legal form of which complies with the literal language of the ITA3; these transactions have no independent commercial purpose, as their purpose is only to avoid taxes that would otherwise be payable or to obtain tax benefits that would otherwise not be available and which are not intended to be conferred by the statutory provisions that are exploited by the transaction. Accordingly, a jurisprudence that privileges legal form over economic substance lays the doctrinal foundation upon which tax avoidance schemes are built. This thesis examines the problem of form and substance in Canadian tax jurisprudence, taking a practical reasoning approach influenced by Ronald Dworkin’s “law as integrity” theory to suggest an approach to the problem that does not follow out-dated British precedents as a matter of faith but rather is horizontally consistent with the norms, values and political morality embodied in the greater body of Canadian law.

3 R.S.C. 1985, c. 1 (5th Supp.), as amended, (hereinafter referred to as the “ITA”).
Chapter 2 outlines the conceptual framework employed in the analysis that follows. That framework may be described as "constructive interpretation" undertaken within a practical reasoning approach. Constructive interpretation takes as its foundation Ronald Dworkin's law as integrity theory of the activities of courts. It seeks to interpret the "legal record as a whole" to arrive at the "right answer" to legal problems. A right answer in Dworkin's theory is one that is integral with or horizontally consistent with the norms, values, and political morality of the community reflected in the larger body of the community's legal principles. Therefore, current Canadian tax jurisprudence will be critiqued against the standards set by the legal system itself. If tax law is insulated from the norms and values that give life to the greater body of the community's law outside of tax, tax law is bound to be regarded as unjust, unfair and backward as any law will be if it is in discord with those norms and values.

Chapter 3 outlines the contours of the form and substance problem in Canadian tax law, tracing its origins from the jurisprudence of the UK and documenting the doctrinal vacillations in the decisions of the Supreme Court of Canada between an approach that prefers form over substance to one that favours substance over form and then, since the late 1990s, a reversion to traditional formalism. Chapter 3 also compares the Canadian approach to the contrastingly consistent substance over form doctrines developed first in the United States beginning in the 1930s and then in the UK from the late 1970s to 2005 when the House of Lords seems to have abandoned substance over form.

Chapter 4 examines the tax policy, political and legal philosophical implications of formalism in tax law to determine whether current Canadian tax jurisprudence is aligned with the community's norms, values, and political morality. The tax policy implications of a formalistic jurisprudence are that it allows tax avoidance to flourish in two ways. First, it prevents the development of judicial anti-avoidance doctrines, and where these already exist, it threatens their continued existence. Second, it prevents statutory general anti-avoidance rules from being effective. The political implications of a formalistic jurisprudence are that, although it is justified by rule of law values, its individualistic and libertarian tendencies constrain and limit

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the legislature, giving a preference to private ordering that inappropriately allows those with the
wherewithal to engage in tax avoidance the ability to pay tax voluntarily. Therefore, formalistic
jurisprudence is plagued by the contradiction that while it is justified by the rule of law, it
actually compromises parliamentary supremacy. Further, it tends to be elitist rather than
democratic. The result is that the collectivist and altruistic foundations of the ITA are frustrated
by the incompatible individualistic laissez-faire values that constitute the political basis for
formalistic jurisprudence. The “legal philosophical” implications relate to a vision of what law
is. Formalistic tax jurisprudence provides a distinctly dystopian vision of law that renders it
merely symbolic and commodified. As a result, current Canadian tax jurisprudence diverges
from society’s norms and values.

In line with Dworkin’s injunction to interpret the legal record as a whole, Chapter 5
considerably widens and generalizes the scope of the analysis, moving beyond tax jurisprudence
to the legal system generally. It situates current formalistic Canadian tax jurisprudence within
the larger legal system to conduct a deep and thorough examination of the question of form and
substance in law generally and then uses norms and principles that emerge from the “legal record
as a whole” to come up with a right answer to the manifestation of the form-substance problem
in tax law. Chapter 5 explains that formal and substantive rules, doctrines, and approaches to
reasoning each have their respective domains within a legal system and that legal systems
usually choose between the two alternatives on the basis of the pragmatic and functional
requirements of the system and the particular legal problem in question. Therefore, it is possible
to rationally design a legal system and to objectively and rationally choose between a formal or
substantive approach to any given problem in order to best promote justice, fairness, and the
effectiveness of the legal system as a whole. Chapter 5 explains that, given these considerations,
the problem of tax avoidance requires the substantive approach of judge-made anti-abuse
doctrines.
2. Conceptual Framework

2.1. New Approaches in Tax Scholarship

Writing in 1998, Professor Livingston evaluated the situation in tax scholarship, noting its limitations, and made recommendations for a newer, more creative tax scholarship that would fit with contemporary developments in the broader legal academy. Livingston argued for a tax scholarship that made greater use of the non-economic social sciences, the insights of non-tax jurisprudence, and one that makes currently peripheral subjects such as international and comparative taxation its primary concerns. A number of elements from Livingston's new approach are appropriate for the study of form and substance in tax jurisprudence. The different approaches to the form and substance problem in the US and UK makes an international comparative approach of particular relevance. The jurisprudence from the latter countries provides insights into the historical and prospective development of Canadian jurisprudence by providing the counterpoint of viable doctrinal alternatives to substantially similar legal problems. Furthermore, the insights from non-tax jurisprudence are essential in determining whether tax jurisprudence is horizontally consistent with the norms and values embodied in the legal system as a whole. Taken together, Livingston hopes that the proposed changes will make tax scholarship both more contemporary and more practical in focus – practical in the sense of decreasing its distance from the legal profession and bridging the gap between the academy and the practicing bar. As this study aims at proposing rational doctrinal changes to the way tax law deals with the form and substance problem, it is practical in focus, dealing with the nuts and bolts of legal reasoning to build a constructive solution to an unresolved doctrinal problem.

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5 Michael A. Livingston, “Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy” (1998) 83 Cornell L. Rev. 365 (arguing that traditional tax scholarship is comfortable but tired, overly normative when most of the academy is experimenting with empirical and narrative forms, methodologically simplistic when the broader academy has become more sophisticated in economics and other disciplines, plagued by a naïve and outdated search for political objectivity).
6 Ibid. at 395.
7 Ibid.
In addition to revitalizing tax scholarship, Livingston predicts that the changes he proposes would "reassert an independent and self-confident role for academic lawyers." By making use of diverse source materials such as noneconomic social science, non-tax jurisprudence, and the insights of practicing lawyers, Livingston expects that legal scholars can avoid the pitfall of becoming "second-tier economists" and can reassert their traditional role as "judges of competing forms of evidence and authors of creative, practical solutions." Livingston describes the methodology that brings together different sources and approaches for the study of tax law as practical reason, by which he means a method that borrows from various intellectual sources without treating any one source as foundational or as necessarily superior. Practical reasoning depends upon the lawyerly skills of reasoning and the weighing of evidence to determine which sources are likely to be most persuasive in the context of any specific problem. While it may be traced to Aristotle, the concept of practical reason is more recently associated with the philosophical movement of pragmatism that is closely associated with William James, Richard Rorty, and others, having as its central idea the notion that "one can seek right or truth in specific cases even in the absence of a universal theory of what is true or right." In keeping with the inclusive nature of a practical reasoning approach, this study will analyze Canadian tax jurisprudence from the perspective of many intellectual sources, including an international comparative approach that draws out insights from the tax jurisprudence of the United States and the United Kingdom, Canadian non-tax jurisprudence, sources related to democracy and the law, and postmodern thought. It is hoped that the sources chosen contribute to a persuasive, reasoned, and principled solution to the form-substance problem in Canada at a time when the jurisprudence of the Supreme Court of Canada has been criticized for clinging to formalism as an "a matter of blind belief, an article of faith". Livingston also suggests that the work of legal philosophers such as Dworkin, Posner, MacKinnon, and similar figures can

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8 Ibid.
9 Ibid.
10 Ibid., Livingston acknowledges that the most common use of practical reason in legal literature is to describe judicial methods of statutory interpretation as an alternative to textualism, purposivism, and other foundational interpretive theories and that he is among the few to use the term to describe scholarly (as opposed to judicial) behavior. However, Livingston finds support in its implicit use in Anthony Kronman’s proposition that prudence or practical wisdom is a welcome alternative to “scientific” methods in legal teaching and scholarship. See Anthony T. Kronman, The Lost Lawyer: Failing Ideals of the Legal Profession (Harvard, Belknap Press, 1993), at 354-64.
11 Ibid.
12 Ibid.

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provide another valuable component to a practical reasoning approach to the study of tax law.\textsuperscript{14} As this study focuses on Canadian tax jurisprudence, it is concerned with adjudication. As such, Ronald Dworkin’s theory of law as integrity, which includes his notion of constructive interpretation, is the best fit. In many ways, Dworkin’s idea of constructive interpretation is the foundational concept for the analysis that follows. The various intellectual sources mentioned above are enlisted in the service of conducting a constructive interpretation of the form-substance problem in tax law to arrive at the solution that best articulates the norms, values and political morality embodied in the law as a whole so that tax jurisprudence can be integral with the those norms and values and, consequently, just and fair.

2.2. **RONALD DWORWIN**

In *Law’s Empire*, Ronald Dworkin focuses on the activities of courts in presenting his view of law as integrity. Dworkin challenged the orthodox view that judges filled in the gaps left by rules of law by using their discretion by, in effect, legislating interstitially when they adjudicated cases.\textsuperscript{15} According to Austin, this was not problematic because judges were merely rectifying the “negligence or the incapacity of the avowed legislator”. In a similar vein, Hart saw rules as “open textured” so that rules worked well in most cases but were sometimes indeterminate at which point the judge must exercise discretion to render initially vague standards determinate. It is Dworkin’s view that discretion in a strong sense does not exist, although he accepted that judges had discretion in a weak sense – that is judges do not make new law (because law has no gaps) but exercise judgment to find the best principle for a particular case from the community’s historical body of legal norms, principles and practices.

According to law as integrity, therefore, it is not helpful to ask whether judges make or find the law. According to Dworkin, they do both and neither.\textsuperscript{16} That is, they engage in a constructive interpretation of the law. Indeed, in common law cases where new doctrines or principles are established, it is absurd to suggest that the judge “found” the law when it did not

\textsuperscript{14} Ibid. at 405.
\textsuperscript{16} Dworkin, *Law’s Empire*, supra note 4 at 225.
exist until the judge formulated it. Dworkin’s idea of interpretation captures the way in which new principles (should) emerge from the community’s historical body of existing values, norms and political morality, all of which are expressed in the community’s laws. Therefore, although a principle may be new, it emerged from and is bound to the past and yet expresses the iteration of that past in a form that speaks to the present moment and provides a guide for future adjudication. Thus, law as integrity assumes that “legal claims are interpretive judgments and therefore combine backward - and forward-looking elements.”17

Accordingly, judges are always constrained by the law in every instance of adjudication. In this sense judges do not legislate or use discretion; instead a judge is controlled by the historical record of the community’s moral and political values and practices. A judge’s interpretation of those moral and political values and practices expressed and applied in the case before her is the integral process by which the community’s collective conception of justice and fairness is articulated in and about the present through the judgment rendered. “The adjudicative principle of integrity instructs judges to identify legal rights and duties ... on the assumption that they were created by a single author – the community personified – expressing a coherent conception of justice and fairness.”18 Therefore, a decision rendered by a judge should, as an ideal, be an expression of the best constructive interpretation of the community’s legal practice (i.e. the totality of its recorded jurisprudence) and that such an interpretation must involve a coherent conception of justice and fairness. It is easy to see how a decision with such characteristics will have the qualities of justice, persuasiveness, correctness, validity and legitimacy, as the standards used to assess the presence of those qualities do not lie in a judge’s idiosyncratic personal morality but in the standards, practices and principles of the community.

The idea of “constructive interpretation” is central to law as integrity. Constructive interpretation is a method used to interpret social practices, literary, legal, and other texts – that is to impose a purpose upon an object or practice, to “make of it the best possible example of the form or genre from which it is taken to belong.”19 Dworkin uses the concept of constructive interpretation

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17 Ibid.
18 Ibid.
19 Ibid. at 52.
interpretation to interpret legal practice and prescribes it as the ideal method of judicial adjudication. However, it must be emphasized that what is interpreted in law as integrity is not a particular statutory provision or other particular text but the legal record as a whole. The process is one in which judges decide hard cases by trying to find, in the legal record as a whole, the best constructive interpretation of the political structure and legal doctrine of their community. Accordingly, the idea of constructive interpretation is creative, as it is concerned with finding new principles in the historical legal record and therefore it is not necessarily concerned with the blind adherence to precedent. The idea of constructive interpretation demands much more from judges. According to Dworkin, “when a judge declares that a particular principle is instinct in law, he reports not a simple-minded claim about the motives of past statesmen, a claim a wise cynic can easily refute, but an interpretive proposal: that the principle both fits and justifies some complex part of legal practice, that it provides an attractive way to see, in the structure of that practice, the consistency of principle integrity requires.” This implies that what is required is not a mechanical application of precedent, as that would not necessarily embody a contemporary and coherent expression of justice and fairness. It may be necessary to modify precedent in light of contemporary jurisprudential, social, political or economic circumstances. Dworkin puts it this way:

History matters in law as integrity: very much but only in a certain way. Integrity does not require consistency in principle over all historical stages of a community's law; it does not require that judges try to understand the law they enforce as continuous in principle with the abandoned law of a previous century or even a previous generation. It commands a horizontal rather than vertical consistency of principle across the range of legal standards the community now enforces. It insists that law – the rights and duties that flow from past collective decisions and for that reason license or require coercion – contains not only the narrow explicit content of these decisions but also, more broadly, the scheme of principles necessary to justify them.

Law as integrity ... begins in the present and pursues the past only so far as and in the way its contemporary focus dictates. It does not aim to recapture, even for present law, the ideals or practical purposes of the politicians who first created it. It aims rather to justify what they did ... in an overall story worth telling now, a story with a complex claim: that present practice can be organized by and justified in principles sufficiently attractive to provide an honorable future.

Therefore, integrity and consistency (treating like cases alike) are not necessarily the same thing. The passage above makes it clear that what matters is the story worth telling now and the

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20 Dworkin, Law’s Empire, supra note 4 at 226.
21 Ibid. at 255.
22 Ibid. at 228.
23 Ibid. 227-228.
decisions of the past are to be justified within a frame of principles that speak to the community’s contemporary notions of fairness and justice, thus achieving horizontal rather than vertical consistency. Integrity requires past decisions to be the subject of a constructive interpretation that will imbue them with the resonance of the community’s contemporary vision of justice and fairness and also with the echo of that vision into the future. For this reason, it may necessary to depart from a narrow line of past decisions “in search of fidelity to principles conceived as more fundamental to the scheme as a whole.”24 Therefore law as integrity may be understood as a scheme for transforming “the varied links in the chain of law into a vision of government now speaking with one voice,” even if that voice is very different from the voice of the law makers of the past.25

A judge engaged in constructive interpretation is not completely free to decide cases according to her whim. Rather, judicial interpretation has two dimensions to constrain judges that have already been implied in the preceding discussion but which deserve a separate elaboration: fit and justification. To explain the idea of fit, Dworkin famously uses the metaphor of the chain novel where “a group of novelists writes a novel striatum; each novelist in the chain interprets the chapters he has been given in order to write a new chapter, which is then added to what the next novelist receives, and so on.”26 This casts the judge in the role of both literary critic (interpreter) and author. In the chain novel analogy, the judge cannot write a new chapter according to her own personal tastes and values. She is constrained by the plot and theme that has come before. The judge must subordinate her personal tastes and values in the interests of making the novel coherent and internally consistent; her chapter must be integral with the whole. However, it must also speak to the present moment and also lay the foundation for the future chapters that must be written. In the case of judicial adjudication, the historical legal record constitutes the source for the judge’s interpretation and the interpretation (the decision on the case at bar) must fit into that existing body of law and speak to the present legal problem in a way that is integral with the past and also lays the foundation for an honourable future in the cases that are to come. The idea of justification is that judges seek to interpret laws

24 Ibi. at 219.
25 Ibi. at 273.
26 Ibi. at 229.
in a way that best justifies them and the entire body of laws according to the best available standards of political morality. According to Dworkin, "[a]n argument of principle can supply a justification for a particular decision . . . only if the principle cited can be shown to be consistent with earlier decisions not recanted, and with decisions that the institution is prepared to make in the hypothetical circumstances" of future cases.\(^{27}\) Therefore, the idea of justification ensures that judges decide cases on the basis of principles and are not embarking upon decisions founded upon policy (which is a legislative function), as policy may be case specific without referring to past policy decisions and influencing future ones.\(^{28}\)

The three chapters that follow are conceived of an exercise in constructive interpretation, the goal being to consider the problem of form and substance in current Canadian tax jurisprudence in light of the historical body of law and to fashion from that history a "present practice [that] can be organized by and justified in principles sufficiently attractive to provide an honorable future."\(^{29}\)

2.3. DWORKIN AND TAX

The use of law as integrity to analyze tax law has been suggested before.\(^{30}\) Tax law scholar, Edward J. McCaffery, gives Dworkin's interpretive theory a privileged significance by locating it in the wider context of the ascendancy of literary criticism within the high culture of Western democracies. The most famous legal manifestation of this development is Dworkin's constructive interpretation. McCaffery suggests that a political-interpretive\(^{31}\) approach is an attractive strategy for tax policy scholarship and analysis to supplement and in some regards replace the reigning methodologies. The interpretive aspect of McCaffery's method refers to "a

\(^{27}\) Ronald Dworkin, "Hard Cases" (1975) 88 Harv. L. Rev. 1057 at 1065.

\(^{28}\) Ibid.

\(^{29}\) See supra, note 19.


\(^{31}\) Although McCaffery advocates a political-interpretive approach, combining the work of Dworkin and Rawls into a broad theoretical framework allowing for a wide set of ideas and principles, both from within and beyond law, to inform an analysis of tax law, I am more restrictive and use an interpretive approach closely in line with Dworkin.
social theory that looks to our actual practices and our at least inchoate beliefs as important source materials for normative reform” and indicates a fidelity to Dworkin’s ideas.32

While McCaffery’s methodological fidelity to Dworkin is obvious, his approach is more political (as it is concerned with policy) and is situated within a practical reasoning approach compared with Dworkin’s focus on adjudication but the method is essentially the same as that developed by Dworkin. For example, a political interpretive approach to tax examines society’s treatment of “like cases” in an attempt to extract principles from practices in an effort to achieve an integrity or horizontal consistency that “will not adhere to the past out of blind fidelity to it, but will require reasons to depart from it.” 33 Following Dworkin, McCaffery points out that a benefit of constructive interpretation is that it has no benchmark principle such as utility with which to justify a break from past practices or cases but rather looks for principles in the practices surveyed.34 If the interpreter happens to be faithful to the past in a particular case, that fidelity is not based upon blind faith in precedent but rather on the pragmatic belief that the past practices of a community embody principles that still speak to a resonate in the present as just and fair.35 McCaffery’s version of constructive interpretation is situated within an overall practical reasoning approach that, at various stages of the analysis “will look to the tools of economics, psychology, political science, and other “non-interpretive” inputs to help guide it.” 36 Therefore, McCaffery’s analysis will always have at least one foot in an actual, contingent, historically situated community and context, and another foot in political, social, and moral theory.37 Because of the multiplicity of source material enlisted, political interpretivism will not be a neat and clean exercise but that is unavoidable. In any event, it is the way judges and lawyers have to reason, and according to Dworkin, is what they in fact do when solving legal

32 Ibid. at 103. Because Dworkin in concerned with interpretive methodology, he is McCaffery’s primary guide but McCaffery also takes much from the social contractarian and political project of John Rawls, who stresses the connection between political theory and the cultural materials surrounding it. McCaffery requires the social contractarian and political principles of Rawls because the focus of his interpretive project is on the policy oriented arena of legislation rather than adjudicative aspect of tax law which is based on principle rather than policy. McCaffery also invokes the concept of a political-interpretive approach to tax in Edward J. McCaffery, “The Political Liberal Case Against the Estate Tax” (1994) 23 Phil. & Pub. Aff. 281; and Edward J. McCaffery, “The Uneasy Case for Wealth Transfer Taxation” (1994) 104 Yale L.J. 283.
33 Ibid.
34 Ibid.
35 Ibid.
36 Ibid. at 95.
37 Ibid.
problems. Therefore, constructive interpretation is more than a prescription for judicial reasoning but is a method of practical reasoning that is versatile enough to be merged with diverse intellectual sources along the lines suggested by Livingston. McCaffery is quite explicit about constructive interpretation's strong association with legal reasoning, noting that Dworkin's method is "[a] style most commonly invoked in the judge-centric areas of the common law, or statutory interpretation or constitutional interpretation" and he thinks that it is necessary to modify it to suit the "seemingly different domain of tax." He appears to imply that there is a distinction between what he considers the "domain of tax" and "judge-centric" domains, further implying that the domain of tax is free from the involvement of judges. I do not necessarily accept the distinction because the domain of tax surely includes the contributions of judges in the adjudication of tax cases. Moreover, the form-substance problem is largely one of principle that arises in the context adjudication rather than in policy based legislative decisions and it is judges in England and America rather than the legislatures in those countries that have created substance over form doctrines to combat tax avoidance. McCaffery must have in mind the creation of tax legislation as opposed to the adjudication of tax cases, the latter being obviously judge-centric. However, the point that is relevant to this study of form and substance in Canadian tax jurisprudence is that Dworkin's constructive interpretation can form the framework for a practical reasoning approach that incorporates diverse intellectual sources such as international comparative law, the social sciences, and the insights from non-tax jurisprudence.

Finally, McCaffery points out that the Dworkin's constructive interpretation has been used by other scholars to study tax law but those scholars did not use the label "interpretivism" or otherwise explicitly acknowledge their methodology. One such scholar is Grace Ganz Blumberg who used an interpretive method in her 1972 feminist study, Sexism in the Code: a Comparative Study of Income Taxation of Working Wives and Mothers which examined the Internal Revenue Code to reveal a pattern of work disincentive for married women and

38 Ibid.
39 See discussion, supra.
inequitable treatment of the two-earner family. Blumberg engaged in a constructive interpretation of the problem within a practical reasoning approach that used a multiplicity of intellectual sources. She discussed the history of various provisions and doctrines under the tax laws, such as joint filing and the treatment of child-care expenses. Incorporating an international comparative approach, she examined practices in Canada, England, and Sweden. Using the social sciences, she considered economic and other sources, culminating in a number of recommendations that resonated with traditional principles of taxation as well as being justified on the basis that they eliminated discrimination against working wives and mothers.

The structure of Blumberg’s argument follows Dworkin’s law as integrity methodology. For example, Blumberg’s concluding section begins: “The pattern of work disincentive embodied in the Internal Revenue Code is entirely inconsistent with the principle of sexual equality enunciated in Title VII and further expanded by the federal and state judiciaries.”41 Blumberg’s project begins with a set of principles (equal concern and respect for women) embodied in the legal record as a whole but external to tax itself and then seeks to read and ultimately reform tax with those principles in mind, achieving integrity and horizontal consistency. Blumberg’s use of the principles of equal concern and respect for women refers to the principle of equality, an element of the community’s political morality that is embodied in the in Declaration of Independence. The latter principle was used by US President Lincoln to condemn slavery and it can be invoked to condemn the inequality and oppression of women in the tax code.42 Therefore, using Dworkin’s “law as integrity” interpretive method, there are right answers to the problem of tax and gender just as there was a right answer in Brown v. Board of Education, the famous American desegregation case, which is one of the examples Dworkin uses in Law’s Empire of an interpretive law as integrity adjudication that applied the principle of equal concern an respect to the problem of segregated schools.

41 Ibid. at 95.
42 McCaffery, “Tax’s Empire”, supra note 30 at 148.
3. The Problem of Form and Substance in Tax Law

3.1. The Nature of the Problem: The Relationship Between Statutory Interpretation and the Characterization of Transactions

In tax law, the problem of form and substance manifests itself in two related aspects of the adjudication of tax cases: the way judges interpret legislation and the way they characterize the taxpayer’s transactions. A formalistic approach to statutory interpretation assumes that there is an objective and fixed literal meaning to the words of a statute and seeks to apply the “literal” words enacted by Parliament without searching for any unexpressed purpose of the provision. Formalistic approaches to statutory interpretation are designated by the terms, textualism, literalism, plain meaning and the like. An approach that characterizes taxpayer transactions according to their legal form, without regard to their underlying economic or commercial reality or substance, is a formalistic approach to the characterization of transactions. To the extent that taxpayers design the legal form of tax-motivated transactions so that they comply with the literal words of the statute but contradict the scheme or purpose of the relevant statutory text or the statute taken as a whole, statutory interpretation and the characterization of transactions “are necessarily linked, since textual interpretive approaches are apt to characterize transactions without regard to taxpayer motivations, while purposive approaches are more likely to characterize or recharacterize transactions in light of the statutory scheme.”

A jurisprudence that engages in a literal interpretation of statutes and insists upon characterizing transactions and relationships according to their legal form creates the perfect

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conditions for tax avoidance, as literalism and formalism are the twin pillars of tax planning.\textsuperscript{44} Formalism has been the approach adopted by the Supreme Court of Canada in tax decisions since the late 1990s, where the court emphasizes the literal or plain meaning of the words of the act and "at the same time, ... has refused to strike down several blatant tax avoidance schemes ... these two themes [formalism in the characterization of transactions and in statutory interpretation] in the tax jurisprudence of the Supreme Court of Canada are ... intimately related."\textsuperscript{45}

Although Canadian tax jurisprudence has lately been formalistic, its history discloses an ambivalent attitude toward form and substance with the jurisprudence vacillating between a preference for form in one historical period, and a preference for substance in another, and, in the current period, a reversion to a preference for form.\textsuperscript{46} Canadian tax law is remarkable for this vacillation between form and substance as tax law in that it has maintained a seemingly unresolved doctrinal tension for decades. Putting aside for a moment the policy and political implications of this phenomenon\textsuperscript{47}, at the very least the equivocation in tax jurisprudence serves to undermine the integrity of tax jurisprudence in particular and jurisprudence generally. By definition, integrity is lost when there is instability and inconsistency. No doubt, the prevalence of the tension between form and substance is underwritten by the fact that the vacillation between the two exists in and is not resolved by the decisions of the Supreme Court of Canada.


\textsuperscript{45} Arnold, "Reflections", supra note 13 at 2.

\textsuperscript{46} It is not the purpose of this thesis to attempt to explain the doctrinal vacillation in tax law but only to describe it in order to identify various viable doctrinal alternatives which are open to common law judges who decide tax cases that present a form-substance problem. Several writers have attempted studies which seek to explain the doctrinal approaches adopted by different courts or by the same court at different times. For example, see Assaf Likhovski, "The Duke and the Lady: Helvering v. Gregory and the History of Tax Avoidance Adjudication" (2004) 25 Cardozo L. Rev. 953 [Likhovski, "The Duke and the Lady"], a comparative study of tax avoidance adjudication in which Likhovski looks at The Duke of Westminster and Gregory v. Helvering, the cases created the two great doctrinal alternatives in UK and US tax law, respectively, to account for the different results and determine what factors influence judges to decide tax avoidance cases in the way that they do. Likhovski proposes an endogenous model in which doctrinal changes in the tax law were influenced by the social and political context in which the decisions were decided. Other relevant studies are referred to in Likhovski's piece including Robert Stevens, Law and Politics: The House of Lords as a Judicial Body, 1800-1976 (Studies in Legal History) (Chapel Hill: University of North Carolina Press, 1978) [Stevens, "Law and Politics"], which examines the history of British tax jurisprudence in the areas of statutory interpretation and anti-avoidance doctrines within a broader analysis of the decisions of the British House of Lords, arguing that the formalistic approaches to tax cases are politically based.

\textsuperscript{47} These are the subject of chapter 4.
The purpose of this chapter is to describe the problem of form and substance as it manifests itself in the tax jurisprudence of the Supreme Court of Canada, to trace its origins from the jurisprudence of the United Kingdom, and to contrast it with more recent developments in the UK as well as to contrast Anglo-Canadian jurisprudence with the jurisprudence of the United States of America.

### 3.2. The British Origins of Formalistic Canadian Tax Jurisprudence

#### 3.2.1. The British Origins of Textualism in Statutory Interpretation

Canadian law has an intimate relationship with British law and the judges who decided the early Canadian tax cases followed the formalistic and textual approach to tax law that was prevalent in the UK in the nineteenth to the late twentieth centuries. This is not surprising because Canadian law, with the exception of the civilian law of Quebec, is largely derived from English sources and appeals were permitted from the Supreme Court of Canada to the Judicial Committee of the Privy Council until 1949. If Canadian courts were subject to review and reversal by a UK body, it is natural that Canadian courts would look to UK jurisprudence to guide their decisions. It is true that, in theory, the JCPC was supposed to decide cases in accordance with the law of the colony from which the decision originated but the members of the JCPC were likely influenced by the doctrines of their own legal system, especially in the case of a colony like Canada which was socially, economically, and legally an offspring of the UK. The nexus between early Canadian and UK law resulted in the import of doctrine from the UK to Canada that has cast an enduring shadow over the development of Canadian tax jurisprudence and has stood as a roadblock in the way of the principled development of the form and substance question in tax law. The equivocating and insular body of Canadian tax jurisprudence now

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48 Duff, "Justice Iacobucci", supra note 38 at 527.
50 Ibid.
51 Ibid.
stands in contrast to other areas of Canadian law, such as contract and property, which have seen the development of form over substance doctrines that resolve the form-substance problem in a sound and rational way.\textsuperscript{52}

The decision often treated as the first in the chronology\textsuperscript{53} of Canadian tax jurisprudence is predictably a UK case, the 1869 decision of the House of Lords in \textit{Partington v. Attorney-General}\textsuperscript{54}. \textit{Partington} is characteristic of the early approach to the interpretation of tax statutes where judges viewed them as penal in nature and sought to resolve ambiguities in the charging provision of a tax statute in favour of the taxpayer.\textsuperscript{55} In \textit{Partington}, Lord Cairns formulated what he called “the principle of all fiscal legislation” in distinctly formalistic terms:

... if the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called equitable construction, certainly such a construction is not admissible in a taxing statute where you simply adhere to the words of the statute.\textsuperscript{56}

Accordingly the first principle of tax jurisprudence was formalism and literalism. That principle found favour in Canada as \textit{Partington} was cited with approval by the Supreme Court of Canada in \textit{The King v. Crabbs}.\textsuperscript{57}

In 1892, Lord Halsbury expressed a similar preference for narrow formalism in \textit{Tennant v. Smith}\textsuperscript{58}:

[i]n a taxing Act it is impossible, I believe, to assume any intention, any governing purpose in the Act, to do more than take such tax as the statute imposes... [I]nasmuch as you have no right to assume that there is any governing object which a taxing Act is intended to attain other than that which it has expressed by making such and such objects the intended subjects of taxation, you must see whether a tax is expressly imposed.\textsuperscript{12}

In 1922, the Supreme Court of Canada affirmed the same approach, explaining that “[a] law

\begin{itemize}
\item[\textsuperscript{52}] See chapter 5.
\item[\textsuperscript{53}] See Duff, “Justice Iacobucci”, \textit{supra} note 38. See also \textit{Stubart Investments Limited v. Her Majesty the Queen} 84 D.T.C. 6305 (S.C.C.) at 6323, per Estey J. [\textit{Stubart}].
\item[\textsuperscript{54}] (1869), 4 L.R. 100 (H.L.) [\textit{Patrington}].
\item[\textsuperscript{56}] \textit{Patrington}, \textit{supra} note 534 at 122.
\item[\textsuperscript{57}] [1934] S.C.R. 523, at 525.
\item[\textsuperscript{58}] [1892] A.C. 50 (H.L.).
\end{itemize}
imposing taxation should always be construed strictly against the taxing authorities since it restricts the public in the enjoyment of its property.” The high watermark of the of the application of Lord Cairns’ pronouncement was the decision of the House of Lords in Inland Revenue Commissioners v. Levene, a case that was interpreted by John Willis as holding that it was “not only legal but moral to dodge the Inland Revenue.”

UK jurisprudence continued with the textual approach to statutory interpretation into the 1970s when the House of Lords reaffirmed the approach in Mangin v. Inland Revenue Commissioners.

3.2.2. The British Origins Formalism in the Characterization of Transactions

If the first pillar of tax planning is formalism in statutory construction, the second is an approach that determines the tax consequences of a transaction (or series of transactions) by characterizing it according to its legal form while ignoring its economic reality or substance even if it was not undertaken for any commercial or business purposes but only to avoid taxes.

The leading case on the formalist approach to the characterization of transactions is the decision of the House of Lords in Commissioner of Inland Revenue v. Duke of Westminster. The Duke of Westminster wanted to deduct from his income the wages and salaries he was paying to his household servants, including his gardener, in order to reduce his surtax liability. The income tax statute did not allow deductions from taxable income for remuneration paid to household servants. However, it did allow deductions for annuities and other “annual payments” that taxpayers made. The Duke obtained his desired deduction by merely changing the legal form of

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59 Canadian Northern Railway Co. v. The Queen (1922), 64 S.C.R. 264 at 275, per Brodeur J.
60 [1921] 1 K.B. 64.
61 Ibid. at 71.
his relationship with his servants: he entered into a "deed of covenant" with them under which he paid them an annuity equal to a portion of their salary for a period of seven years. The Duke's lawyers advised the servants that in addition to the annuity payments they were entitled to claim their salary. However, the servants were told that "it is expected that in practice you will be content with the provision that is being legally made for you so long as the deed takes effect, with the addition of such sum (if any) as may be to bring the total periodical payment while you are still in the Duke's service up to the amount of the salary or wages which you have lately been receiving." The Inland Revenue Commissioner assessed the Duke by disallowing his claimed deduction for the "annuity" payments and treated them as non-deductible remuneration to household servants.

The Duke appealed the assessment, arguing that the "annuity" payments could be deducted from his income for the purpose of calculating his surtax liability. The Inland Revenue Commissioner countered that rather than give primacy to the legal form of the transaction, the court may 'ignore the legal position and regard what is called "the substance of the matter"'. The House of Lords rejected the argument. Such a substantive approach, warned Lord Tomlin, using the language of Sir Edward Coke, would 'involve substituting "the uncertain and crooked cord of discretion" for the "golden and straight metwand of the law"' adding his influential statement that:

Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciated the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.67

The House grounded its decision on the fact that the deed itself stated that the servants were not prevented from "being entitled to and claiming full remuneration for such further work as [they] may do." Therefore, even though the economic substance of the relationship did not change, the new legal form of the relationship determined the tax consequences.

66 Ibid. at 12.
67 Ibid. at 19.
68 Ibid. at 11-12.
The connection between the characterization of transactions for tax purposes and the interpretation of tax statutes is articulated by the concurring opinion of Lord Russell where he confesses that he views with disfavor "the doctrine that in taxation cases the subject is to be taxed if, in accordance with a court's view of what it considers the substance of the transaction, the court thinks that the case falls within the contemplation of the statute. The subject is not taxable by inference or analogy, but only by the plain words of a statute applicable to the facts and circumstances of his case." 69 For Lord Russell, substance was form and little else: "[t]he substance of the transaction between Allman [the gardener] and the Duke is in my opinion to be found and to be found only by ascertaining their respective rights and liabilities under the deed." 70 Lord Wright said much the same: '[t]he true nature of the legal obligation and nothing else is "the substance"' 71 as did Lord Atkin: "I agree that you must no go beyond the legal effect of the agreements and conveyances made, construed in accordance with ordinary rules in reference to all the surrounding circumstances." 72 These passages express the doctrine that a person is taxable only if the legal form of what he has done falls within the literal words of the statute and is not taxable if the legal form is outside the letter of the law but within the spirit of the law. In addition, strict interpretation implies that unless consideration of motive is required by the words of a statutory provision, a taxpayer's motive or purpose for entering into a particular transaction is not relevant in determining the tax consequences of the transaction. 73 It is often said that to do otherwise would be an affront to the rule of law. Defense of the rule of law is one of the foremost justifications for formalistic tax jurisprudence, even if it comes at the expense of others who do not have the financial, circumstantial, or other means to engage in legal avoidance. One example of what tax jurisprudence will tolerate in the name of the rule of law comes from a passage from Lord Simon of Glaisdale:

It may seem hard that a cunningly advised taxpayer should be able to avoid what appears to be his equitable share of the general fiscal burden and cast it on the shoulders of his fellow citizens. But for the Courts to try to stretch the law to meet hard cases (whether the hardship appears to bear on the individual taxpayer or on the general body of taxpayers as represented by the Inland Revenue) is not merely to make bad law but

69 Ibid. at 20.
70 Ibid. at 24-25. The notion that substance is form and nothing else has been used an argument in criticism of the US business purpose test. See Joseph Isenbergh, "Musings on Form and Substance in Taxation" (1982) 49 U. Chi. L. Rev. 859 at 879 ("When we are dealing with statutory terms of art, the form-substance dichotomy is a false one. "Substance" can only be derived from forms created by the statute itself. Here substance is form and little else; there is no natural law of reverse triangular mergers.") [Isenbergh, "Musings"].
71 Ibid. at 31.
72 Ibid.
73 Arnold, "Reflections", supra note 13, at 6.
to run the risk of subverting the rule of law itself. Disagreeable as it may seem that some taxpayers should escape what might appear to be their fair share of the general burden of national expenditure, it would be far more disagreeable to substitute the rule of caprice for that of law.74

Canadian courts have faithfully followed this principle and so it is important to point out that it is followed at the expense of “the alternative to the Duke of Westminster principle on which our tax system could be based [which] is the more appealing principle that everyone should pay his or her fair share of tax. Such a principle is consistent with equity, basic morality, and good citizenship.”75

The Duke of Westminster illustrates the Anglo-Canadian emphasis on form, both in the textual interpretation of tax statutes and in the characterization of transactions and relationships in accordance with their legal form rather than their substantive economic reality. Essentially, the twin pillars of tax avoidance have been enshrined in Canadian law.76 However the tolerance of English and Canadian courts is not without limits. The courts of both countries were and are prepared to ignore incomplete or sham transactions. The term “sham” in Anglo-Canadian jurisprudence is taken to refer to transactions that are “intended to give to third parties or the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create.”77

74 Ransom v. Higg, (1974) 50 Tax Cas. 1 at p. 94.
76 Sherbaniuk, “Tax Avoidance”, supra note 44.
77 Snook v. London & West Riding Investments Ltd., [1967] 1 All E.R. 518 at 528 (C.A.), per Lord Diplock. This definition of “sham” was approved by the Supreme Court of Canada in M.N.R. v. Cameron, [1972] C.T.C. 380, 72 D.T.C. 6325 (S.C.C.), per Maitland J. The American definition of “sham,” as the term is used in tax cases, differs somewhat from the Anglo-Canadian definition. American courts have held that a transaction is a sham if it lacks a business purpose even when the legal relations created by the parties are in reality what they purport to be and there was no element of deceit, see Knetsch v. United States, 364 U.S. 361 (U.S.S.C). The latter approach to sham was taken in Canada in the case of M.N.R. v. Leon (1976), 76 D.T.C. 6299 (F.C.A.) where Justice Heald, speaking for the court, stated, “[i]f the agreement or transaction lacks a bona fide business purpose, it is a sham.” However, if Leon brought forth a new rule in tax law, the rule was effectively discarded when the Leon rule was “confined to the facts of that case” by the Federal Court of Appeal a year later in Massey-Ferguson Ltd. v. The Queen (1977), 77 D.T.C. 5013 at p. 5020. Further, it was dismissed as obiter by the Supreme Court of Canada in Stubart, supra note 53 at 6318.
3.3. Substance and Form in the United States

One year after the *Duke of Westminster*, the Supreme Court of the United States rendered its decision in *Gregory v. Helvering*. The latter decision is the doctrinal mirror image of the former. There are two reasons for discussing *Gregory*. First, the case demonstrates that Anglo-Canadian formalism in tax law is but one of the doctrinal alternatives open to common law judges when adjudicating tax cases where the exploitation of form and substance results in abusive tax avoidance. Second, *Gregory* gave birth to the American economic substance (or business purpose) doctrine, which was advocated by the Crown but rejected by the Supreme Court of Canada in *Stubart*. Moreover, the economic substance doctrine still haunts Canadian tax jurisprudence as illustrated by recent Supreme Court of Canada decisions, where the Crown argued unsuccessfully that economic substance was part of the GAAR analysis.

The facts of *Gregory* are as follows. Mrs. Gregory was the sole owner of the United Mortgage Corporation which in turn held shares in Monitor Securities Corporation that had a market value of $133,333 in 1928 at which time Gregory decided to sell them. There were two ways of accomplishing this:

1. United could sell its shares of Monitor, pay the tax on the sale and distribute the after tax profits on the sale to Gregory. The distribution from United to Gregory would have to be by dividend and the dividend would be taxed in Gregory’s hands as ordinary income.
2. The Monitor shares could be distributed to Gregory as a dividend and then sold by her, in which case the Monitor shares transferred to Gregory would be taxed as ordinary income.

However, Gregory desired to sell the Monitor shares and pay only the capital gains tax rate (which was lower than the rate for ordinary income) while simultaneously reducing the amount that was taxed. To accomplish this Gregory took advantage of the tax-free “reorganization” provisions contained in section 112(g) of the Revenue Act of 1928. She claimed that the following steps constituted a corporate reorganization:

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78 *Gregory v. Commissioner*, 27 B.T.A. 223 (1932), rev’d, 69 F.2d 809 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935) [*Gregory*].
79 *Stubart*, supra note 53.
80 See chapter 4.
1. Gregory created a new corporation (Newco) wholly owned by her. The sole purpose of Newco was to reduce Gregory's taxes; it had no bona fide business purpose.

2. United transferred the Monitor shares to Newco.

Three days later, Newco was liquidated and Gregory received the Monitor shares that were Newco’s sole assets. Gregory immediately sold the Monitor shares, claiming that she received them as a liquidating dividend, which was taxable as a capital gain. She also claimed that the gain was only $76,000, which was the market price less their cost to her. As such, the separation of assets from United would be tax-free, and the subsequent liquidation of the second corporation would give rise to capital gains in the hands of Gregory as the shareholder who had received the distribution of shares. The result of the transaction, however, was the same as a simple dividend distribution from United (which would carry a higher amount of income taxed and a higher tax rate) and the Commissioner sought to tax it as such arguing that Newco should be disregarded and that the receipt of the Monitor shares by Gregory should be treated as if United sold the shares and distributed the proceeds as a dividend to her.

The Board of Tax Appeals found for the taxpayer on a literal interpretation of the term “reorganization”, which was a defined term in the 1928 Revenue Act, in an analysis that is reminiscent of the traditional Anglo-Canadian approach. The Board viewed the concept of “reorganization” as a legal form created by the statute rather than as a concept drawn from the real world of economic, business, or commercial activity. Finding for the taxpayer, Judge Sternhagen held, in language that would be at home in any of the Anglo-Canadian cases discussed above, that “a statute so meticulously drafted must be interpreted as a literal expression of the taxing policy and leaves only the small interstices for judicial consideration.” The Tax Review Board was reversed by Justice Learned Hand writing for the Second Circuit in what has become arguably the most influential judicial opinion in American tax law. Before discussing those aspects of the decision which have given rise to the American economic substance doctrine, it is worth pointing out that in American jurisprudence such a doctrine is not inconsistent with Lord Tomlin’s influential statement from the Duke of Westminster set out earlier in this chapter. Justice Hand expressed substantially the same sentiment in Gregory:

82 Ibid.
We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity because it is actuated by a desire to avoid. Or, if one chooses, to evade, taxation. Anyone may so arrange his affairs that his taxes shall be as low as possible; there is not even a patriotic duty to increase one’s taxes.

Notwithstanding that principle, Justice Hand went on to find against Mrs. Gregory using a purposive interpretation of the reorganization rules in the Revenue Act that required a “reorganization” to have economic substance and business purpose for it to be a “reorganization” within the meaning of the statute.

Justice Hand held that on a textual approach to the definition of “reorganization”, what occurred may satisfy the literal words of the definition, but that was not enough. Anticipating the discussion of late-1990s Canadian jurisprudence reviewed below, it is worth pointing out that Justice Hand expressly rejected the idea that a statute as detailed and as particularly drafted as the revenue code should be subjected to a textual interpretation, declaring that “no degree of particularity can ever obviate recourse to the setting in which all appear and which all collectively create.”

In the light of that statement it is not surprising that Justice Hand held that the statutory definition of “reorganization” would not apply to Gregory’s transactions, “as a melody is more than the notes” so the “meaning of a sentence may be more than that of the separate words.”

The latter passages are clearly confined to the sphere of statutory interpretation and adopt a purposive approach which would have been sufficient to dispose of the case in favour of the revenue authority. But Justice Hand went further in a passage which contains “in germ a theory of business purpose and tax avoidance”:

It does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. ... The purpose of the [reorganization] section is plain enough: men engaged in enterprises – industrial, commercial, financial or any other – might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as “realizing” any profit, because the collective interests still remained in solution. But the underlying presumption 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 shareholder’s taxes is not one of the transactions contemplated as corporate “reorganizations.”

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84 Gregory, supra note 78 cited to 69 F.2d at 811.
85 Ibid. at 811.
86 Isenbergh, “Musings”, supra note 70 at 869.
87 Ibid.
88 Gregory, supra note 78 cited to 69 F.2d at 810-11.
Justice Hand’s language emphasizes that he is not determining the purpose of the statute from legislative history but from the business context in which the statute was drafted. His touchstone is economic, business, and commercial reality rather than legalistic forms. The tax benefit in *Gregory* was disallowed because the reorganization spinoff, although real in the sense of being legally effective and not a sham, had no economic substance as it did not change Ms. Gregory’s economic position and was not related to the ongoing conduct of United’s business but was merely a short lived entity that existed only to contravene the code’s purpose of “taxing capital in a business context.” The decision of the United States Supreme Court affirming Justice Hand’s opinion was written by Justice Sutherland, who said:

> [F]ixing on the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose -- a mere device which put on the form of a corporate reorganization as a disguise for concealing its true character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. . . . In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of the [statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. . . . To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

With that, Justice Hand’s business purpose doctrine was firmly established in American tax jurisprudence.

Starting from *Gregory*, American courts developed a broad judicial anti-avoidance doctrine that disregarded transactions with no business purpose and thus put substance before form in American tax law. Another way of viewing the logic and reason behind the business purpose doctrine was stated by Justice Learned Hand in *Gilbert*:

> The Income tax Act imposes liabilities on taxpayers based upon their financial transactions, and it is of course true that 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 it sought to impose.

The importance of the above passage is its characterization of economic substance as a natural tax avoidance concept that prevents the abuse of the tax statute. It recognizes that statutory rules

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90 Ibid. at 1031.
91 *Gilbert v. Commissioner of Internal Revenue*, 248 F. 2d 399 (2nd Cir. 1957).
were written with an eye to the real world of commerce and that abuse arises when statutory rules become detached from the real world of substantive activity and become empty forms. If rules are mere empty forms, it is easy for lawyers to “move symbols around pieces of paper and [their clients] never pay taxes” because real substantive activity is irrelevant. Moreover, the idea that judges “cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities it sought to impose” is critical as it honours the supremacy of the legislature by giving full force to its enactments. It also casts judges in the appropriate role of encouraging compliance with the enacted law, rather than enabling the abuse of the formal rules enacted by the legislature and the unfairness of the few casting their fiscal burden upon the many through judicially sanctioned tax avoidance schemes. Justice Hand’s approach, therefore, is consistent with democracy, justice, and fairness.

Another illustration of the economic substance doctrine is found in Court Holding Co. where a corporation negotiated the sale of assets to an arms-length buyer. However, when the agreement was to be reduced to writing, the corporation’s lawyer advised against the sale because of the tax consequences. To avoid tax, the corporation was liquidated with its assets distributed to the shareholders in exchange for their stock. The shareholders then sold the assets to the buyer on essentially the same terms as were negotiated between the corporation and the buyer. The purpose of the plan was to avoid corporate tax so that only the shareholders would pay tax on the distribution they received. The revenue authority sought to disregard the liquidation and have the corporation pay tax on income earned from the asset sale. The court held for the Commissioner of Revenue, reasoning that “[t]he incidence of taxation depends on the substance of the transaction.” The court found that the liquidation was a “mere formalism” that set the shareholders up as a “conduit” through which title passed to the buyers.

The modern form of the economic substance doctrine was fashioned in the decision of the US Supreme Court in Frank Lyon Co. v. The United States, which cast the doctrine in the form of a two-pronged test. The first prong determines whether the transaction has objective

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93 324 U.S. 331 (1945).
94 Isenbergh, “Musings” supra note 70 at 872.
95 Frank Lyon Co. v. United States, 435 U.S. 561, at 583-84 (1978)
economic substance and the second prong looks to determine whether the taxpayer had a subjective business motivation. The case involved a sale-leaseback transaction. The taxpayer borrowed $7.1 million and used the loan together with $500,000 of its own money to buy a building from a bank for $7.6 million. It then turned around and leased the building (for a 25 year term and option to renew for 40 more years) back to the bank for rent which equaled $7.1 million plus the interest the taxpayer paid to the bank. The lease also provided the taxpayer with a fixed rate of return for its investment of $500,000. The taxpayer claimed depreciation deductions as the legal owner of the building and deductions in respect of interest payments on the bank loan. The US Supreme Court found that the transactions were not a sham but that did not “compel the further conclusion that Lyon is entitled to the items claimed as deductions.” The court stated that:

... where ... there is a ... transaction ... 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.  

Therefore, the court would find for the taxpayer if the sale-leaseback transaction had a tax-independent business purpose and “the economics of the transaction were authentic.”

The current version of the economic substance doctrine may be dated to the 1998 decision of the Third Circuit in ACM Partnership v. Commissioner. The court in ACM analyzed the taxpayer’s transactions against the economic substance test, which it described as a two pronged objective and subjective test:

The inquiry into whether the taxpayer’s transactions [have] sufficient economic substance to be respected for tax purposes turns on both the “objective economic substance of the transactions” and the “subjective business motivation” behind them. However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a “rigid two-step analysis,” but rather represent related factors both of which

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96Ibid.
97Miller, “Corporate Tax Shelters” supra note 89 at 1040.
98 157 F.3d 231 (3d Cir. 1998) [ACM]. As Joseph Bankman points out, “it is useful but somewhat arbitrary” to use ACM as the origin of the latest version of the doctrine: Joseph Bankman, “The Economic Substance Doctrine” (2000) 74 S. Cal. L. Rev. 5, at 8 [Bankman, “The Economic Substance Doctrine”]. Bankman notes out that the doctrine has its origin in and incorporates language form the following decisions: Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Knetsch v. United States, 364 U.S. 361 (1960); Gregory, supra note 78; Goldstein v. Comm’r, 364 F.2d 734 (2d Cir.1966) and that more recent iterations of the doctrine are found in Lerman v. Comm’r, 939 F.2d 44 (3d Cir. 1991); Horn v. Comm’r, 968 F.2d 1229 (D.C. Cir.1992); Kirchman v. Comm’r, 862 F.2d 1486 (11th Cir. 1989); Rose v. Comm’r, 88 T.C. 386 (1987), aff’d, 868 F.2d 851 (6th Cir. 1989); Rice’s Toyota World, Inc. v. Comm’r, 81 T.C. 184 (1983), aff’d in part and rev’d in part, 752 F.2d 89 (4th Cir. 1985).
inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.99

The court defined the objective prong of the test as asking "whether the transaction has any practical economic effects other than the creation of income tax losses."100 The subjective prong looks at whether the taxpayer has shown that it had a business purpose for engaging in the transactions other than tax avoidance. However, tax code intended to confer some tax benefits to taxpayers independent of any non-tax purpose. Thus, "the doctrine cannot apply where a sensible reading of text, legislative intent, and purpose suggest it should not apply."101

Although there is some criticism102 of the economic substance doctrine in American courts, it has received a generally favourable reception. American commentators view the doctrine as having an "important and constructive role to play in [the American] tax system"103 and have said that, "[t]o combat corporate tax shelters, the Commissioner's most effective tool is the common law economic substance doctrine, which allows a court to disregard a transaction if it lacks economic substance,"104 a view that is shared by the American Treasury Department.105 The utility of the economic substance doctrine is fairly obvious. Without it, the revenue authority would be unable to disallow tax benefits on the basis of technical non-compliance with the statute because the tax avoidance transactions are designed and structured to comply with the literal language of the statute. As suggested by Weisbach and Shaviro, the unconstrained use of black letter rules could lead to the elimination of "wholesale swathes of corporate income tax liability."106

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99 ACM, ibid. at 247 (citations omitted).
100 Ibid. at 248.
101 Bankman, "The Economic Substance Doctrine", supra note 98 at 13. Bankman gives the example of "a decision by a corporate taxpayer to invest in housing subject to low-income tax credit. The tax credit was enacted to stimulate investment in low-income housing. A taxpayer who, at the margin, makes the investment solely because of tax reasons is presumably doing just what the lawmakers who enacted the legislation would have wished. (Legislation influences investment only by changing behaviour of taxpayers at the margin). Yet the investment is necessarily one that does not have a favourable before-tax return."
102 There have been calls for the US Supreme Court to revisit the doctrine due to inconsistent application in lower courts, see e.g. Yoram Keinan, "It is Time for the Supreme Court to Voice its Opinion on Economic Substance" (2006) 7 Hous. Bus. & Tax L.J. 93.
104 Miller, "Corporate Tax Shelters", supra note 89 at 1017.
3.4. A CHANGE OF APPROACH: SUBSTANCE OVER FORM IN THE UK

In the UK, the formalistic approach to the characterization of relationships and transactions seems to have been abandoned in 1982 when the House of Lords decided *WT Ramsay Ltd. v. IRC*¹⁰⁷ and particularly the subsequent case of *Furniss v. Dawson*¹⁰⁸ in 1984. These cases seemed to establish a judicial business purpose test similar to the American test established in *Gregory*.¹⁰⁹ In *Ramsay* the issue was whether losses created under two separate tax avoidance schemes involving a series of transactions were artificial and consequently should be ignored for tax purposes. The Inland Revenue Commissioner urged the House of Lords to so hold even though the transactions that gave rise to the losses were complete, genuine, and were in reality what they purported to be, meaning that there was no sham. The taxpayers intended to use a synthesised capital loss to offset a previously realized capital gain. When the transactions were viewed as a whole, it was clear that the transactions were intended to be self-cancelling. Lord Wilberforce concluded that the transactions were pure tax avoidance mechanisms that had no independent commercial or business purpose. The House of Lords dismissed the taxpayers’ appeals and held that they were to be assessed without regard to the synthesised loss. Lord Wilberforce offered the following reasons, which emphasised the economic reality of transactions over their legal form:

The capital gains tax was created to operate in the real world, not that of make-belief. As I said in *Aberdeen Construction Group Ltd. v. Inland Revenue Commissioners* [1978] A.C. 885, it is a tax on gains (or I might have added gains less losses), it is not a tax on arithmetical differences. To say that a loss (or gain) which appears to arise at one stage in an indivisible process, and which is intended to be and is cancelled out by a latter operation, is not such a loss or gain as the legislation is dealing with, is in my opinion well and indeed essentially within the judicial function.¹¹⁰

The significance of *Ramsay* was discussed in *Burmah Oil Co. Ltd.*¹¹¹, another decision of the House of Lords that involved a complex tax avoidance scheme undertaken through a series of planned transactions. The Inland Revenue Commissioner relied explicitly on *Ramsay* as the foundation for its position that the transaction should be disregarded as artificial. The House of

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¹⁰⁸ [1984] AC 474 [*Furniss*].
¹⁰⁹ Note 78, supra.
¹¹⁰ *Ramsay*, supra note 107 at 326.
Lords found against the taxpayer, holding that the taxpayer suffered no real loss. The significance of *Ramsay* was discussed in the reasons for judgment of Lord Diplock:

It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that *Ramsay*’s case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable. The difference is in approach. It does not necessitate the over-ruling of any earlier decisions of this House; but it does involve recognizing that Lord Tomlin’s oft-quoted dictum in *Commissioners of Inland Revenue v. Duke of Westminster*, “every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be’, tells us little or nothing as to what methods of ordering one’s affairs will be recognized by the courts as effective to lessen the tax that would attach to them if business transactions were conducted to lessen the tax that would attach to them if business transactions were conducted in a straightforward way.\(^{112}\)

This was interpreted as an adoption of the American economic substance or business purpose test into British law.\(^{113}\) It is useful to quote a passage from Lord Templeman’s speech from the Court of Appeal’s decision in *Ramsay*, as it provides an articulate description of when a transaction lacks economic substance. According to Lord Templeman, a transaction has no economic substance if it is merely a “game”:

> 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 the Bottom did don an ass’s head so that tax advantage can be claimed as if something had happened.\(^{114}\)

Subsequently, the substantive shift in UK jurisprudence was reinforced by the decision of the House of Lords in *Furniss v. Dawson*\(^{115}\) where Lord Brightman set out the *Ramsay* principle as follows:

> First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end … Secondly, there must be steps inserted which have no commercial (business) *purpose* apart from the avoidance of a liability to tax – not “no business effect.” If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.\(^{116}\)

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\(^{112}\) Ibid. at 536.


\(^{115}\) Note 108, *supra*.

\(^{116}\) Ibid. at 527.
Therefore, Furniss and Ramsay were a shift in UK jurisprudence toward an American-style substance test in which transactions were to be characterized according to the end result and steps in a transaction which had no business or commercial purpose were to be disregarded for the purposes of applying the income tax statute.\(^{117}\)

However, recently the House of Lords has equivocated and returned to the formalist approach in *Barclays Mercantile Business Finance Ltd. v. Mawson*\(^{118}\), which has reaffirmed “the primacy of construction of the particular taxing provision and the illegitimacy of rules of general application” and has “killed off the Ramsay doctrine as a special theory of revenue law and subsumed it within the general theory of the interpretation of statutes...and opened the door to tax avoidance”\(^{119}\). It appears that if there ever was a substance over form business purpose test in the UK, the House of Lords firmly rejected it in *Barclays* where Lord Nicholls, delivering the decision on behalf of all members of the House said, “[c]ases such as these ... give rise to a view that, in the application of any taxing statute, transactions or elements of transactions which had no commercial purpose were to be disregarded. But that is going too far.”\(^{120}\) In so holding, the House of Lords affirmed earlier decisions in *MacNiven v. Westmoreland Investments Ltd.*\(^{121}\) and *Scottish Provident Institution*\(^{122}\) and thus solidified the recent formalistic turn in UK jurisprudence.

\(^{117}\) However, some commentators have said that “even in this, the strongest formulation of the “principle,” lack of business purpose alone was no: enough to remove the effectiveness of a tax-avoidance scheme; all depended on the wording of the statute.” See e.g. Judith Freedman, “Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance” (2005) 53 Can. Tax J. 1038 at 1040.

\(^{118}\) *Barclays Mercantile Business Finance Ltd. v. Mawson* [2005] AC 685 (HL) (*Barclays*).


\(^{120}\) *Barclays, supra* note 118 at paragraph 36.

\(^{121}\) [2003] 1 AC 311 (H.L.).

\(^{122}\) [2004] UKHL 52 (H.L.).
3.5. **THE SUPREME COURT OF CANADA’S TAX DECISIONS FROM THE LATE 1970s TO THE EARLY 1990s: TOWARDS SUBSTANCE OVER FORM**

The Supreme Court of Canada’s tax decisions from the late 1970s to early 1990s began to depart from textualism in statutory interpretation and form over substance in the characterization of transactions. The first case that signaled a change of approach was *Moldowan v. The Queen*, where the court employed a purposive approach to the interpretation of section 31 of the ITA, which restricted the deduction of losses from farming "[w]here the taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income." The court rejected a literal interpretation of the provisions, “according to which it would either always apply (since farming could not be a ‘chief source of income’ in a taxation year in which it resulted in a loss) or almost never apply (since the arithmetic ‘combination’ of a farm loss and income from the taxpayer's most important other source would generally constitute a ‘chief source’”). Three years later Justice Dickson’s dissenting opinion in *Covert et al. v. Nova Scotia (Minister of Finance)* sought to abolish the distinction between the approach to the interpretation of taxation statutes and all other statutes with the latter receiving a purposive interpretation and the former a strict interpretation. His reasons also speak critically of the blind acceptance of the legal form of a taxpayer’s transactions. The case involved a bequest to an Alberta corporation that was intended to avoid Nova Scotia succession duty. The appellants argued that courts should strictly construe tax statutes and consider only the “legal effect” of transactions, without regard to their “true substance.”

According to Justice Dickson, as he then was,

> If the submissions made on behalf of the appellants, as to the proper principles to be applied in constructing fiscal legislation, simply mean that it is impermissible to bring to the task of construing a fiscal statute a bias in favour of the Crown, then I am in entire accord. A Court of justice must act as a neutral umpire, impartially and objectively, between the taxpayer and the taxing authority. Neither occupies a preferred position.

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123 Duff, “Justice Iacobucci”, *supra* note 38 at 531.
125 ITA, *supra* note 3, ss. 31(1) (in *Moldowan* the Court dealt with subsection 13(1) of the 1952 *Income Tax Act*, the language of which is identical to the present subsection 31(1)).
126 Duff, “Justice Iacobucci”, *supra* note 38 at 531.
128 Ibid. at 806.
If, on the other hand, the submissions of the appellants mean that there are special principles of construction governing the interpretation of fiscal legislation, or that a court must uncritically and supinely accept the form of the transaction, blind as to what is actually happening, then, with respect, I disagree. Fiscal legislation does not stand in a category by itself. Persons whose conduct a statute seeks to regulate should know in advance what it is that the statute prescribes. A court should ask -- what would the words of the statute be reasonably understood to mean by those governed by the statute. Unnatural or artificial constructions are to be avoided.

The correct approach, applicable to statutory construction generally, is to construe the legislation with reasonable regard to its object and purpose and to give it such interpretation as best ensures the attainment of such object and purpose.129

The emphasized passage above leaves little doubt that for Justice Dickson textualism in statutory interpretation and a preference for form over substance in the characterization of transactions should be abandoned in favour of purposive statutory interpretation and a critical evaluation of the legal form of the transaction together with close attention to “what is actually happening” in a transaction.

The pivotal case in this era of the Supreme Court of Canada’s tax jurisprudence is Justice Estey’s decision in *Stubart Investments Ltd.* 130 in which the Supreme Court of Canada adopted a purposive approach to the interpretation of tax statutes but refused to recognize an economic substance or business purpose test that would have firmly altered Canadian tax jurisprudence by placing the economic substance of a transaction before its legal form. As context for his discussion of the proper approach to the interpretation of tax statutes, Justice Estey described the changing role of the ITA in Canadian society, stating that it is “no longer a simple device to raise revenue to meet the cost of governing the community” but that it also serves as a tool that the government uses to attain various economic and other policy goals and objectives. 131 As a consequence of that changing role, Justice Estey declared that that the application of strict construction to the Act has “receded”. 132 He held that the ITA should be interpreted, like any other statute, according to Professor Driedger’s “modern rule”, which states that the words of a statute are to be construed “in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of

129 Ibid. at 807 [emphasis added].
130 See note 53, supra.
131 Ibid. at 6322.
132 Ibid. at 6323.
Parliament.\textsuperscript{133} Two years later, in \textit{Golden v. The Queen}, Justice Estey reaffirmed this conclusion:

In \textit{Stubart} . . . the Court recognized that in the construction of taxation statutes the law is not confined to a literal and virtually meaningless interpretation of the Act where the words will support on a broader construction a conclusion which is workable and in harmony with the evident purposes of the Act in question. Strict construction in the historic sense no longer finds a place in the canons of interpretation applicable to taxation statutes. . . . \textsuperscript{134}

With that, it seemed certain that textualism or literalism in the interpretation of tax statutes was dead.

Turning to the question of the characterization of transactions or relationships in \textit{Stubart}, the Supreme Court of Canada did not abandon the preference for legal form over economic substance. The transactions at issue in \textit{Stubart} involved the asset sale of Stubart's food flavouring business to a related company purchaser, Grover Cast Stone Company Limited, which was in the business of precast concrete and which had accumulated substantial losses that were recognized under the ITA as available to offset taxable income in future years. Both Stubart and Grover were wholly owned subsidiaries of the same parent corporation. The goal of the tax avoidance plan was for Stubart to route its income through Grover and avail itself of Grover's accumulated tax losses and thereby shelter its own income from tax. Pursuant to the agreement under which the sale proceeded, Stubart continued to operate the food flavouring business as Grover's agent and the net income from the business was remitted to Grover by Stubart. Grover reported the income on its tax returns and applied its accumulated tax losses to shelter that income from tax. The business was sold back to Stubart after Grover's accumulated losses were exhausted. The economic substance of the transactions was that Stubart was always the owner of the business and was the entity that earned the income and on that basis the Minister of National Revenue reassessed the income to Stubart. The sale of the business to Grover had no business or commercial purpose; the purpose was solely the avoidance of tax by shifting income from one corporation to another that had the ability to shelter it from tax. For that reason, the Minister "asked the court to find, without express statutory basis, that no transaction is valid in the income tax computation process that has not been entered into by the taxpayer for a valid

\textsuperscript{133} Ibid. (citing Elmer A. Driedger, \textit{Construction of Statutes}, 2d ed. (Toronto: Butterworths, 1983) at 87).
business purpose.” The Minister expressly relied on the UK decisions of Ramsay and Furniss, and the American case of Gregory to persuade the court to recognize a business purpose test in Canadian jurisprudence.

Preferring form over substance, the court held that the transfer and sale of the business was legally valid and complete and that it was not a sham transaction – that is to say that it was not constructed so as to create a false impression in the eyes of the taxation authority and that the appearance created by the documentation was precisely the reality - and rejected the Minister’s business purpose argument. The court reasoned that a business purpose test would contradict parliament’s intent to use tax incentives to encourage certain activities and to attain desired economic and policy goals:

A strict business purpose test in certain circumstances would run counter to the apparent legislative intent which, in the modern taxing statutes, may have a dual aspect. Income tax legislation, such as the federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no bona fide business purpose. Thus, by imposing a positive requirement that there be such a bona fide business purpose, a taxpayer might be barred from undertaking the very activity Parliament wishes to encourage.

The court’s reasons for the rejection are curious because the income tax statutes of the UK and US use taxation to implement policy objectives in the form of tax incentives for certain activities, yet the business purpose test has not caused any problems in relation to such incentives. In fact, the test has existed in American jurisprudence since 1933 without any legislative abrogation or even any serious movement to have it abolished by Congress. In a concurring judgment, Justice Wilson relied upon the Duke of Westminster, illustrating its continuing hold on Canadian jurisprudence and its status as an enduring barrier to its development. According to Justice

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135 Stubart, supra note 53 at 6308.
136 See note 107, supra.
137 See note 108, supra.
138 See note 78, supra.
139 Stubart, supra note 53 at 6321.
140 Ibid at 6322.
141 See note 65, supra.
Wilson, “Lord Tomlin’s principle is far too deeply entrenched in our tax law for the courts to reject it in the absence of clear statutory authority.”

Having rejected the business purpose approach, the court indicated that it was in favour of a purposive approach to the interpretation of the ITA:

It seems more appropriate to turn to an interpretation test which would provide a means of applying the Act so as to affect only the conduct of a taxpayer which has the designed effect of defeating the expressed intention of Parliament. In short, the tax statute, by this interpretative technique, is extended to reach conduct of the taxpayer which clearly falls within 'the object and spirit' of the taxing provisions.

Within this interpretative approach, the court acknowledged that in some circumstances the “formal validity” of a transaction might be ignored where the “‘object and spirit’ of [an] allowance or benefit provision is defeated by . . . procedures blatantly adopted by [a] taxpayer to synthesize a loss, delay or other tax saving device. . . .” Otherwise,” he concluded, “where the substance of the Act, when the clause in question is contextually construed, is clear and unambiguous and there is no prohibition in the Act which embraces the taxpayer, the taxpayer shall be free to avail himself of the beneficial provision in question.” Among the supposed salutary effects of this approach, Justice Estey considered that it was a “simple rule which will provide uniformity of application of the Act across the community, and at the same time, reduce the attraction of elaborate and intricate tax avoidance plans, and reduce the rewards to those best able to afford the services of the tax technicians.” Further, Justice Estey believed that the approach would be “appropriate to reduce the action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally-guided and equally specialized taxpayer reaction”. However, Stubart appears to have “had the opposite effect, as taxpayers at times became more aggressive in their tax planning and tax avoidance activities.” As aggressive tax avoidance plans proliferated, the

142 Stubart, supra note 53 at 6325.
143 Ibid. at 6322.
144 Ibid. at 6324.
145 Ibid. at 6324.
146 Ibid. at 6322.
147 Ibid. at 6324.
Federal Government realized that it was facing a serious shortfall in corporate tax revenues.\(^{149}\) As a result, the Federal Government announced in 1987 that it would introduce a statutory business-purpose test in the form of a general anti-avoidance rule (GAAR).\(^{150}\) As Brian Arnold has pointed out, “the GAAR is an especially important provision in the context of the Canadian tax system because Canadian courts have rarely used judicial anti-avoidance doctrines, such as substance over form, sham, or business purpose, to prevent abusive tax avoidance.”\(^{151}\) In his Budget speech, the then Minister of Finance made the following remarks which illustrate the unsatisfactory fiscal climate that existed following *Stubart*:

> I am concerned that abusive tax-avoidance transactions are a significant factor in eroding corporate tax revenues. They also undermine respect for the integrity of our tax system. Such schemes permit some corporations – often large and profitable – to avoid paying income tax.

> The government has acted repeatedly to curb these and other such abuses with a series of specific rules. Where required, the government will continue this practice. In addition, to ensure a fairer and more stable income tax system, I intend to propose improved general anti-avoidance rules as part of tax reform.\(^{152}\)

However, it was not until September 2005 that the Supreme Court of Canada considered and applied the GAAR (these decisions are considered at the end of this chronology and their implications are discussed in chapter 4).\(^{153}\)

Meanwhile, perhaps sensing the fiscal damage wrought by *Stubart*, in a number of subsequent decisions the Supreme Court of Canada began to move in the direction of substance over form in the characterization of transactions.\(^{154}\) In *Johns-Manville Canada Inc. v. The Queen*,\(^{155}\) the Minister of National Revenue assessed the taxpayer as having made a capital

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\(^{150}\) ITA, *supra* note 3, s. 245.


\(^{152}\) Canada, Department of Finance, 1987 Budget Speech, February 18, 1987, 11.


\(^{154}\) See Duff, “Justice Iacobucci”, *supra* note 38 at 536-541.

expenditure whereas the taxpayer wished the expenditure to be characterized as a current expenditure allowing it to deduct the full amount in the current year. A unanimous court stated that the distinction between a current expenditure and a capital expenditure should depend on “a commonsense appreciation of all the guiding features” of the expenditure, or “what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of legal rights”.

The question of whether a transaction is on revenue or capital account has much in common with the American economic substance doctrine in that it involves the characterization of valid legal transaction, in this case the acquisition of land, for the purposes of determining the tax treatment it will receive. The concept of capital is present in the ITA but is not defined. In order to give meaning to the concept, the court assumed that the Act was meant to apply to real transactions undertaken for substantive commercial and business purposes because it is the commercial and business context of the expenditure that will determine its characterization and hence its tax treatment. In other words, the reference point for the court is the real world of economic and business activity rather than the symbolic world of legal rights and juristic classifications. Furthermore, it employs the use of a judge-made standard to make functional sense out of the ITA rather than relying simply on the provisions of the statute formally interpreted.

In Imperial General Properties Ltd. v. The Queen, the Minister assessed the taxpayer on the basis that it was “controlled” by and therefore “associated” with a family holding company. The holding company held no more than 50 per cent of Imperial’s voting shares but held 90 per cent of its common shares. Notwithstanding the fact that the holding company did not hold over half of the voting shares, a majority of the court dismissed the taxpayer’s appeal. The majority held that the taxpayer’s relationship to the holding company was one of “control.

157 Ibid. at paragraph 42, citing Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation, (1946), 72 C.L.R. 634 (Aust. H.C.) at 648, per Dixon J.
158 See chapter 5.
in the real sense of the term."\textsuperscript{160} In contrast to the result in \textit{Imperial}, David Duff points out that earlier Supreme Court of Canada decisions had interpreted the concept of corporate control as the \textit{de jure} right to elect a majority of the board of directors.\textsuperscript{161} Nevertheless, in \textit{Imperial} Justice Estey emphasized substance over form declaring that:

\begin{quote}
In determining the proper application of [the relevant statutory provision] to circumstances before a court, the court is not limited to a highly technical and narrow interpretation of the legal rights attached to the shares of a corporation. Neither is the court constrained to examine those rights in the context only of their immediate application in a corporate meeting.\textsuperscript{162}
\end{quote}

Therefore, the reference point for the court was, once again, the real substance of the relationship.

\textit{Bronfman Trust v. The Queen}\textsuperscript{163} is often regarded as the high watermark of the substantive approach to the characterization of transactions in the Supreme Court of Canada.\textsuperscript{164} In \textit{Bronfman}, the Minister assessed the taxpayer to disallow the deduction of interest expenses on borrowed money used to finance capital distributions to its sole beneficiary on the basis that the borrowed money was not "used for the purpose of earning income from a business or property" as required by section 20(1)(c)(i) of the \textit{ITA}. Bronfman Trust's main argument was that the borrowed funds were used \textit{indirectly} to earn income from property, since they allowed it to "retain income-producing investments".\textsuperscript{165} The court rejected the argument, holding that subparagraph 20(1)(c)(i) required that borrowed funds must be directly used to earn income in order for interest to be deductible and finding as a fact that the borrowed funds were not used even indirectly to earn income. In the words of Chief Justice Dickson, writing for a unanimous court:

\begin{quote}
\textsuperscript{160} Ibid. at paragraph 14.
\textsuperscript{162} \textit{Imperial General Properties}, \textit{supra} note 159 at paragraph 16.
\textsuperscript{163} [1987] 1 C.T.C. 117, 87 D.T.C. 5059 (S.C.C.) [\textit{Bronfman Trust} cited to D.T.C.].
\textsuperscript{164} David G. Duff, "Justice Iacobucci", \textit{supra} note 38 at 538.
\textsuperscript{165} \textit{Bronfman Trust}, \textit{supra} note 163 at 5065.
In my view, the text of the Act requires tracing the use of borrowed funds to a specific eligible use, its obviously restricted purpose being the encouragement of taxpayers to augment their income-producing capacity. This, in my view, precludes the allowance of a deduction for interest paid on borrowed funds which indirectly preserve income-earning property but which are not directly “used for the purpose of earning income from . . . property”.  

In addition to the main argument about indirect use of the borrowed funds, Bronfman Trust advanced an alternative argument that it could have deducted the interest expenses if it had sold assets to pay the allocations to beneficiaries and then borrowed money to replace the assets. The court found it sufficient to dismiss this argument on the basis that “the courts must deal with what the taxpayer actually did, and not what he might have done.” However, the court pointed out that the hypothetical transactions would be “the epitome of formalism” and that the court may regard such a transaction as “a formality or a sham designed to conceal the essence of the transaction, namely that the money was borrowed and used to fund a capital allocation to the beneficiary.” In support of this form over substance approach, the court cited the decision of the Tax Review Board in Zwaig v. M.N.R in which the taxpayer used the proceeds from the sale of securities to purchase a life insurance policy, and then borrowed on the policy to repurchase the securities. Chief Justice Dickson pointed out that “[t]he Tax Review Board rightly disallowed the deduction sought for interest payments, notwithstanding that the form of the taxpayer's transactions created an aura of compliance with the requirements of the interest deduction provision.” True, it may be said that the court’s comments in favour of a substance over form approach were not necessary to decide the case and are therefore obiter, as its initial conclusions that the borrowed funds were not directly or indirectly used to earn income and that the hypothetical transactions were not carried out were sufficient to decide the case. However, it is significant that the court’s initial conclusions were bolstered by a more substantive argument based on “a real appreciation of the taxpayer's transactions” and the “essence” of the hypothetical transactions. The decision in Bronfman Trust “stands out for its explicit disapproval of the traditional Anglo-Canadian approach, according to which tax consequences

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166 Ibid. at 5067.
167 Ibid. at 5061.
168 Ibid. at 5068.
169 Ibid.
171 Bronfman Trust, supra, note 163 at 5068.
172 David G. Duff, “Justice Iacobucci”, supra note 38 at p.539.
173 Bronfman Trust, supra note 163 at 5067.
174 Ibid.
should depend on the legal form of transactions and relationships regardless of their commercial or economic reality.” With respect to the latter point, the court could not have been clearer:

... just as there has been a recent trend away from strict construction of statutes (see Subart ... and ... Golden . . .), so too has the recent trend in tax cases been towards attempting to ascertain the true commercial and practical nature of the taxpayer's transactions. There has been, in this country and elsewhere, a movement away from tests based on the form of transactions and towards tests based on what Lord Pearce has referred to as a 'common sense appreciation of all the guiding features' of the events in question: B.P. Australia Ltd. v. Commissioner of Taxation of Australia, [1966] A.C. 224 at 264; [1965] 3 All E.R. 209 at 218 (P.C.).

The court deliberately recognized the “trend” or “movement” of Canadian jurisprudence away from formalism towards a more substantive approach to the interpretation of tax statutes and the characterization of transactions for tax purposes. The court went further and described this trend as “laudable ... provided that it is consistent with the text and purposes of the taxation statute” for the reason that:

[a]ssessment 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.

It seemed that the communitarian values of fairness and equality had entered tax jurisprudence and supplanted the individualism of the Duke of Westminster principle, replacing it with an emphasis on substance over form.

Following the decision in Bronfman Trust, Chief Justice Dickson had an opportunity to summarize the development of Canadian tax jurisprudence in his 1991 decision in McClurg v. Canada where, speaking for the court, he described the development of Canadian tax jurisprudence as “the development of an interpretive approach to the Income Tax Act” and that the interpretive approach that the Supreme Court of Canada had adopted in the decisions since Stubart required the court “to determine both the purpose of the legislative provision and the

175 David G. Duff, “Justice Iacobucci”, supra note 38 at p.539.
176 Bronfman Trust, supra note 163 at 5067.
177 Ibid.
178 Ibid.
179 See Arnold, “Reflections”, supra note 13 at 7 (“...the alternative to the Duke of Westminster principle on which our tax system could be based is the more appealing principle that everyone should pay his or her fair share of tax. Such a principle is consistent with equity, basic morality, and good citizenship.”).
181 Ibid. at 1049.
economic and commercial reality of the taxpayer’s actions.”\textsuperscript{182} The court seemed firm in its rejection of the traditional \textit{Duke of Westminster} approach. However, this apparent doctrinal conviction was not destined to endure and the traditional approach reasserted itself, a return that coincided with personnel changes to the composition of the Supreme Court of Canada, which saw the substantive jurisprudence of Justices Estey and Dickson replaced by the formalism and textualism of Justices Iacobucci, Major, and McLachlan.

\section*{3.6. Return to Formalism in the Supreme Court of Canada}

With the Supreme Court’s decision in \textit{Antosko v. The Queen}\textsuperscript{183} Canadian tax jurisprudence returned to formalism in the interpretation of the ITA. In \textit{Antosko}, the Minister argued that the taxpayers should not be entitled to a deduction that was not intended by the applicable statutory provision. Writing for the court, Justice Iacobucci rejected the argument, relying on a textual interpretation of the ITA; he discussed the purposive approach to interpretation established by \textit{Stubart} and then set out the following principle, which can be described a formalistic approach to interpretation:

While it is true that the courts must view discrete sections of the \textit{Income Tax Act} in light of the other provisions of the Act and of the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality, such techniques cannot alter the result where the words of the statute are clear and plain and where the practical effect of the transaction is undisputed.

... Where the words of the section are not ambiguous, it is not for this Court to find that the appellants should be disentitled to a deduction because they do not deserve a “windfall”, as the respondent contends.\textsuperscript{184}

The “plain meaning” approach was reaffirmed one year later in \textit{Friesen v. The Queen}.\textsuperscript{185} In \textit{Friesen}, the taxpayer purchased land in 1982 with the intention of reselling it at a profit but the market value declined and the property was foreclosed in 1986. The taxpayer sought to deduct the decline in market value as a business loss in its 1983 and 1984 taxation years using subsection 10(1) of the ITA which permits inventory to be valued at the lower of cost or market

\textsuperscript{182} Ibid.
\textsuperscript{183} [1994] 2 C.T.C. 25, 94 D.T.C. 6314 (S.C.C.) [cited to D.T.C.].
\textsuperscript{184} Ibid. at 6320 and 6321.
\textsuperscript{185} [1995] 2 C.T.C. 369, 95 D.T.C. 5551 (S.C.C.) [cited to D.T.C.].
A majority of the Supreme Court allowed the deduction on the basis that this result was authorized by a “plain reading” of the relevant statutory provisions. In so doing, the majority accepted the Antosko approach to the interpretation of the ITA when it said that “the plain meaning of the relevant sections of the ITA is to prevail unless the transaction is a sham.” The majority also accepted the following formalistic statement from P.W. Hogg’s *Notes on Income Tax* (3rd ed. 1994):

> It would introduce intolerable uncertainty into the *Income Tax Act* if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court’s view of the object and purpose of the provision … [the Antosko case] is simply a recognition that “object and purpose” can play only a limited role in the interpretation of a statute that is as precise and detailed as the *Income Tax Act*.

When a provision is couched in specific language that admits of no doubt or ambiguity in its application to the facts, then the provision must be applied regardless of its object and purpose. Only when the statutory language admits of some doubt or ambiguity in its application to the facts is it useful to resort to the object and purpose of the provision.

By the time of the Supreme Court of Canada’s decision in *Friesen*, a majority of the court had rejected purposive interpretation in favour of the more textualist approach that characterized the court’s decisions prior to *Stubart*. In *65302 British Columbia Ltd. v. R.* Justice Iacobucci described the rationale for a textual approach to the interpretation of the ITA this way:

> attention must be paid to the fact that the Act is one of the most detailed, complex, and comprehensive statutes in our legislative inventory and courts should be reluctant to embrace unexpressed notions of policy or principle in the guise of statutory interpretation.

It is illustrative to juxtapose these reasons to those of Justice Hand in *Gregory* where he said that: “no degree of particularity can ever obviate recourse to the setting in which all appear and which all collectively create.” Clearly, the approach a court takes to statutory interpretation is not cannot be determined simply from the nature of a taxation statute. Rather, it seems that

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186 Ibid. at 5552.
187 Ibid. at 5564.
188 Ibid. at 5553.
189 Ibid.
190 To highlight the doctrinal instability of the Supreme Court’s tax jurisprudence it is worth noting that, in contrast to *Friesen*, in the same year that it decided the latter case, the court endorsed a purposive approach to the interpretation of the ITA in *Corporation Notre-Dame de Bon-Secours v. Québec*, [1994] 1 C.T.C. 241, 95 D.T.C. 5017 (S.C.C.), a decision that ran counter to the overall thrust of the court’s jurisprudence from the period perhaps because of the case’s sympathetic facts, which involved a non-profit society that provided low rental housing to over 450 indigent elderly persons.
192 Ibid. at 833
193 See note 78, supra.
194 Ibid. cited to 69 F.2d at 811.
judicial values and the conception that judges have of their role in tax avoidance cases is predominant. American courts obviously see it as their role to combat abusive tax avoidance whereas Canadian courts see their role as one of assisting taxpayer in avoiding the clutches of the tax collector.

Just as the Supreme Court of Canada returned to textual statutory interpretation, it returned to an approach that characterized transactions and relationships according to their legal form. In Shell Canada v. The Queen the taxpayer engaged in a tax arbitrage transaction “designed to generate fully deductible interest expenses on a weak currency loan and a partly taxable foreign exchange gain when the debt was subsequently repaid”. The Minister sought to limit the taxpayer’s interest deduction on the basis that the deduction claimed did not reflect the economic realities of the situation. The Minister lost at the Tax Court but was successful at the Federal Court of Appeal where Justice Linden interpreted the relevant statutory provision as restricting the deduction of interest “to those amounts which were reasonable and reflected the economic realities of the situation.” The Supreme Court rejected that interpretation and found for the taxpayer on the basis that, “absent a provision of the Act to the contrary or a finding that they are a sham, a taxpayer’s legal relationships must be respected in tax cases” and that “a searching inquiry for either the ‘economic realities’ of a particular transaction or the general object and spirit of the provision at issue can never supplant a court’s duty to apply an unambiguous provision of the Act to a taxpayer’s transaction.” It has rightly been said that the economic substance doctrine has been “substantially wiped out” by “by the Supreme Court of Canada’s decision in Shell Canada.”

The result was similar in Singleton v. The Queen, another case dealing with the deductibility of interest. In a transaction that became known as the “Singleton Shuffle”, a

197 ITA, supra note 3, ss. 20(1)(c)(i).
198 Shell Canada, supra note 195 at 634.
199 Ibid. at 641.
200 Ibid. at 641-42
201 Innes et al., The Essential GAAR, supra note 148 at 21; see also Arnold, “Reflections”, supra note 13 at 19 (remarking that the economic substance doctrine was “eviscerated” by the Supreme Court’s decision in Shell Canada).
partner in a law firm succeeded in converting what would have been undeductable home-mortgage interest into deductible interest paid for the purpose of earning income. Singleton withdrew $300,000 in equity from his law firm to buy a home and simultaneously obtained a bank loan of $300,000 to replace the withdrawn equity. The Minister argued that the borrowed money was used to finance the purchase of a personal residence and not to finance the purchase of a business investment. The Supreme Court allowed the deduction of interest on the bank loan on the basis that, applying Shell Canada, courts must not "search for the economic realities" of transactions, but should instead assess transactions to give "effect to the legal relationships."204

In 2005, the Supreme Court of Canada finally heard its first two GAAR cases, Canada Trustco205 and Matthew206. In the interests of brevity, I will confine the following discussion to the decision in Canada Trustco. Canada Trustco involved a complex sale-leaseback transaction that, in the court's simplified summary, was described 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 Transamerican 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 TLI, the original owner. TLI them 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.207

The economic substance of the transactions was that they were a purchase of trailers by Canada Trustco and then a sale back to the vendor with return of the purchase price to Canada Trustco and the Minister assessed Canada Trustco as such, treating its cost of the trailers for the purposes of the capital cost allowance (CCA) deductions as zero. Canada Trustco treated the cost stated in the transaction documents ($120 million) as the capital cost of the trailers for the purposes of taking CCA deductions on them in the computation of its profit. For Canada Trustco it was crucial to have the cost of $120 million recognized, as the only return that it earned from the

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203 Ibid. at paragraph 31.
204 Ibid. at paragraph 32.
205 See note 153, supra.
206 Ibid.
207 Canada Trustco, supra note 153 at paragraph 3.
transactions was the generation of CCA deductions that sheltered other taxable lease income it earned.\textsuperscript{208} For example, in the 1997 taxation year, the sale-leaseback transaction allowed Canada Trustco to deduct $31,196,000 in capital cost allowance against leasing income of $51,787,114.\textsuperscript{209} In assessing Canada Trustco, the Minister of National Revenue invoked the GAAR and argued that the object and spirit of the CCA 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” and that the circular sale-leaseback transaction involved “no real risk” and the taxpayer “did not actually spend $120 million to purchase the trailers” such that Canada Trustco created a “cost for CCA purposes that is an illusion”.\textsuperscript{210} Therefore, Canada Trustco “incurred no real economic cost, and thus was not entitled to any “recognition for money spent to acquire qualifying assets”.\textsuperscript{211} Canada Trustco relied on the Tax Court’s conclusion that the transaction was a profitable commercial transaction that complied with the object and spirit of the Act and that “cost” in the context of the CCA provisions means “cost as understood at law, namely the amount paid” rather than economic cost or the “amount at risk”.\textsuperscript{212} The court agreed with the position of Canada Trustco and rejected the Crown’s argument for the following reasons:

The appellant’s submissions on this point amount to a narrow consideration of the “economic substance” of the transaction, viewed in isolation from a textual, contextual and purposive interpretation of the CCA provisions. It did not focus on the purpose of the CCA provisions read in context of the Act as a whole, to determine whether the tax benefit fell outside the object, spirit or purpose of the relevant provisions. Instead, it simply argued that since there was (as it alleged) no “real economic cost”, the GAAR must apply. As discussed earlier, the application of the GAAR is a complex matter of statutory interpretation in which the object, spirit and purpose of the provisions giving rise to the tax benefit are assessed in light of the requirements and wording of the GAAR. While the “economic substance” of the transaction may be relevant at various stages of the analysis this expression has little meaning in isolation from the proper interpretation of specific provisions of the Act. Any “economic substance” must be considered in relation to the proper interpretation of the specific provisions that are relied upon for the tax benefit.\textsuperscript{213}

The decision confirms that Canadian law continues to respect the \textit{Duke of Westminster} principle that there is no economic substance test in Canadian tax law (unless resort to economic substance is explicitly required by specific provisions of the act) and that the existence of the GAAR did

\textsuperscript{208} Ibid. at paragraph 2.
\textsuperscript{209} Ibid.
\textsuperscript{210} Ibid. at paragraph 70.
\textsuperscript{211} Ibid.
\textsuperscript{212} Ibid. at paragraphs 71 and 72.
\textsuperscript{213} Ibid. at paragraph 76.

With respect to statutory interpretation, the Supreme Court said that the GAAR did not abrogate the Duke of Westminster principle (that taxpayers are entitled to arrange their affairs to minimize the amount of tax payable) and the emphasis on textual interpretation but merely “attenuated”. Far from abandoning formalism, the court stated that notwithstanding the GAAR the ITA remains “an instrument dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation.”\footnote{Canada Trustco, supra note 153 at paragraph 13 (‘To the extent that the GAAR constitutes a “provision to the contrary” as discussed in Shell (at paragraph 45), the Duke of Westminster principle and the emphasis on textual interpretation may be attenuated.’)\footnote{Ibid. at paragraph 11.}} Just prior to this statement, the court noted that “the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation. Where parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.”\footnote{Ibid. at paragraph 11.} Thus it appears that the dominant Canadian approach to the interpretation of tax statutes will continue to be formalistic, at least in respect of those provisions that are detailed, explicit provisions dictating specific consequences. However, as noted by the court those are the kinds of provisions that dominate the Act.\footnote{Note that David Duff is of the view that, although one may conclude that the decision reaffirms the plain meaning approach to statutory interpretation, that view is probably mistaken in light of the following passage from paragraph 47 of the decision, which Professor Duff views as a more pragmatic approach to interpretation: Even where the meaning of a particular provisions may not appear to be ambiguous at first glance, statutory context and purpose may reveal or resolve latent ambiguities. “After all, language can never be interpreted independently of its context, and legislative purpose is part of the context. It would seem to follow that consideration of legislative purpose may not only resolve patent ambiguity but may, on occasion, reveal ambiguity in apparently plain language. However, the resort to legislative purpose to resolve ambiguity has always been part of the plain meaning approach. For example, the Supreme Court has stated in a number of cases (see Friesen v. The Queen, [1995] 2 CTC 369 (SCC)) that if the words of the provision in question were clear and unambiguous, they must simply be applied without regard to the purpose of the provision. For criticism of the Supreme Court’s comments on statutory interpretation see Arnold, “Confounded Worse Confounded”, supra note 151 at 177-179.}
3.7. **Conclusion**

The history of Canadian tax jurisprudence is characterized by a periodic vacillation between formalistic and substantive approaches with formalism being the traditionally and currently favoured approach. This is in contrast to American jurisprudence, which has been consistently substantive since the 1930s. UK jurisprudence had a robust substance over form doctrine during the 1980s and 1990s only to revert to formalism with the 2005 decision of *Barclays Mercantile*\(^\text{218}\). The instability of Canadian and UK jurisprudence in and of itself causes it to lack integrity. By definition, there can be no integrity where there is instability. The instability of Anglo-Canadian jurisprudence suggests that competing norms, values, and political moralities are at stake in tax jurisprudence. Judges from one period to the next lack conviction in one alternative or the other, causing them to move back and forth between form and substance.

It is evident in many of the formalistic decisions surveyed in this chapter that formalism privileges the ingenuity of the individual by allowing cunningly advised taxpayers to shift their fiscal burden on to others such as employees who have few opportunities to engage in avoidance transactions. All this is at the cost of values such as equality, fairness, and the principle that everyone should pay their fair share of the national fiscal burden. However, the very fact that Anglo-Canadian jurisprudence has not always been formalistic calls into question whether the values of formalism make tax jurisprudence the best that it can be in the sense of making it fit with the norms, values, and political morality of the community as expressed in the legal record as a whole. Perhaps substantive approaches in tax jurisprudence fit much better with the legal record as a whole.

Given the fact that substantive approaches to tax avoidance cases are legitimate, viable and, in America at least, deeply entrenched, it is necessary to deeply examine the formalism that prevails in Canada to determine whether it is horizontally consistent with the larger body of Canadian law and integral with the norms, values and political morality that expresses itself in that law. The first step in that investigation is an examination of the tax policy, political and legal philosophical implications of formalism.

\(^{218}\) See note 118 *supra*. 

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4. The Implications of Form over Substance in Tax Law

This chapter examines the tax policy, political, and legal philosophical implications of formalism in tax jurisprudence. The tax policy implications of a formalistic jurisprudence are that it allows tax avoidance to flourish in two ways. First, it prevents the development of judicial anti-avoidance doctrines, and where these already exist, it threatens their continued existence. Second, it prevents statutory general anti-avoidance rules from being effective. Therefore, formalistic tax jurisprudence produces the unhappy consequence of a gap in lawmaking where judges steeped in a formalistic jurisprudence fail to develop standards, doctrines, or approaches to combat abusive tax avoidance unless there is a statutory provision compelling them to take on such a role, but when parliament enacts such a statutory provision, the same formalistic tradition prevents the provision from having meaningful effect.

The political implications of a formalistic jurisprudence are that, although it is justified by rule of law values, its individualistic and libertarian tendencies constrain and limit the legislature, giving a preference to private ordering that inappropriately allows those with the wherewithal to engage in tax avoidance the ability to pay tax voluntarily. Therefore, formalistic jurisprudence is plagued by the contradiction that while it is justified by the rule of law, the limitation of the legislature amounts to a subversion of the rule of law. The result is that the collectivist and altruistic foundations of the ITA are frustrated by the incompatible individualistic laissez-faire values that constitute the political basis for formalistic jurisprudence.

The legal philosophical implications relate to a vision of what law is. Formalistic tax jurisprudence provides a distinctly dystopian vision of law. Instead of law being a system to regulate human affairs, formalistic jurisprudence renders it hollow and merely symbolic, a commodified technology of private ordering that can be purchased by taxpayers with the
requisite resources in order to allow them to step beyond the reach of the rule of law and determine for themselves their legal obligations to contribute to the national expenditure.

This chapter is divided into five sections. Sections 4.1, 4.2, and 4.3 discuss the tax policy, political, and legal philosophical implications of formalism, respectively. Section 4.4 offers some concluding remarks.

4.1. THE TAX POLICY IMPLICATIONS OF FORMALISM

4.1.1. Formalistic Tax Jurisprudence is the Doctrinal Foundation for Abusive Tax Avoidance

Canadian and UK jurisprudence both have a common doctrinal origin. Notwithstanding that common origin, the two countries diverged with the UK adopting an American-style business purpose test and Canada remaining formalistic. Because of their common root, a close examination of the doctrinal shifts that led to substance over form in the UK will help to identify, through contrast, the reasons why Canadian jurisprudence remains formalistic and the consequences of that formalism.219 Such an examination also permits the identification of the policy implications that were consciously recognized by the House of Lords as accompanying the doctrinal shift in UK tax jurisprudence.

The discussion appropriately begins with the observation that tax avoidance cases are often framed as statutory interpretation problems.220 For example, the American substance over form doctrine has been characterized as a judicially created rule for the interpretation of tax statutes.221 This suggests that a court’s approach to statutory interpretation in tax cases will determine whether it adheres to a formal or substantive approach to the characterization of taxpayer transactions. That proposition is best illustrated with reference to the Duke of

219 See discussion at section 3.2, supra.
220 See generally Arnold, “Reflections”, supra note 13; See also Bankman, “The Economic Substance Doctrine”, supra note 98. This does not mean that the question is entirely one of statutory interpretation. The way courts treat tax avoidance is often closely related to statutory interpretation but the more general policy question of how a given tax system should view tax avoidance is not related to issues of interpretation: David A. Weisbach, “Ten Truths about Tax Shelters” (2002) 55 Tax L. Rev. 215.
Westminster principle that a person is subject to tax only if he or she is within the clear meaning of the words of the statute; the principle derives from the strict interpretation of the taxation statute. One only needs to recall the facts of the Duke of Westminster and the reasoning of the House of Lords - that led to its rejection of the Inland Revenue Commissioner’s argument that the economic substance of the Duke’s transactions should govern the application of the tax statute\(^{222}\) - to know that the doctrine of economic substance over legal form in the characterization of transactions is incompatible with strict interpretation. This is because strict interpretation offers no room to find that parliament intended a provision to apply to transactions with economic substance unless the same is explicitly stated in the provision under consideration. Of course, it is not necessary that economic substance will be required of transactions when tax provisions are considered purposively but a purposive approach allows the court to hold that the provision in question was meant to apply to transactions with real economic substance and does not apply to blatant tax shelter arrangements.\(^{223}\)

The connection between strict construction and tax avoidance is clear in the jurisprudence of the House of Lords from the 1990s when the House rejected the Duke of Westminster principle, or at least seriously limited its application. For example, in McGuckian\(^{224}\) the court reviewed the development of UK tax law over the previous 30 years. The court noted that during the 30 years leading up to McGuckian there was a shift in British jurisprudence generally away from literalist approaches to purposive ones but that tax law “was left behind as some island of literalist interpretation”, remaining remarkably resistant to the non-formalist methods of interpretation taking hold in most other areas of the law. The court then noted that “literal interpretation of tax statutes and the formalistic insistence on examining steps in a composite scheme separately” so that if the steps were not a sham or legally ineffective the court would not go behind the form of the individual transactions “allowed tax avoidance schemes to flourish to the detriment of the general body of taxpayers.”\(^{225}\) Such was the state of UK tax law before the abandonment of formalism, a state identical to that of current formalistic Canadian tax jurisprudence. From the reasons in McGuckian, it is evident that part of the justification for the

\(^{222}\) See discussion at section 3.2.2, supra.
\(^{223}\) Arnold, “Reflections”, supra note 13 at 23.
\(^{225}\) Ibid. at 915.
The comments of the House of Lords in *McGuckian* are a clear acknowledgement of the connection between tax avoidance and formalistic statutory interpretation but they are also significant in that they characterize the doctrinal shift from form to substance as one towards greater integrity in UK tax jurisprudence. For example, the court notes that tax jurisprudence has for too long been isolated from developments in the greater body of law, in particular the new non-formalist methods of interpretation, indicating that the court conceives of the shift in UK tax jurisprudence as one that achieves horizontal consistency and brings it into harmony with the values that expressed in non-tax jurisprudence. Therefore, the court considers formalism in tax law to be a last vestige of an outmoded approach and for that reason alone there is cause to reject it in favour of integrity with the greater body of law. Furthermore, the court’s reference to “the detriment of the greater body of taxpayers” indicates a fidelity to the political morality of the community that would likely abhor the skewed judicial shifting of the fiscal burden that formalistic jurisprudence implies. Moving on to the proper judicial role in tax avoidance cases, the court considers it inappropriate for judges to tolerate tax avoidance simply because of a habit of employing formalistic jurisprudence when a the practice fails to resonate with present conceptions of justice and fairness. Clearly, a judiciary that has allowed itself to become

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226 Ibid.
227 Ibid.
228 Ibid., at 915 [McGuckian].
marginalized by formalism to the point of becoming a “mesmerized spectator” is risking an abdication of its role in the legal system. Therefore, if formalism in statutory interpretation is responsible for the judicial tolerance of tax avoidance, the necessary implication is that in order to end judicial tolerance of tax avoidance the doctrine of formalistic statutory interpretation must be discarded.

The recognition that formalistic jurisprudence is incompatible with a judiciary that conceives of its role as one that does not tolerate or facilitate tax avoidance identifies one of the tax policy implications of formalistic jurisprudence: it is ill suited to addressing abusive tax avoidance. Formalism renders courts incapable of solving the problem. The obvious result is that state revenue authorities seeking to fight tax avoidance in the courts will meet with very little success unless they are able to convince the court that the avoidance transaction is a sham or otherwise legally ineffective. It is no wonder, therefore, that the formalistic jurisprudence of the Supreme Court of Canada has caused it to bless many “blatant tax avoidance schemes.”

As noted above, judicial tolerance of tax avoidance was only possible in an environment where judges saw themselves as playing no role in the prevention of tax avoidance but rather saw themselves as spectators whose role was to focus narrowly upon the legal relationships created and the literal words of the act. In the UK, during the time when the House of Lords changed its view of its role in tax cases from that of mesmerized spectator to the much more appropriate judicial role of principled adjudicator and arbiter, it replaced the formalism of the Duke of Westminster with purposive interpretation along with its corollary, a substantive and realistic approach to the characterization of taxpayer transactions, to deny taxpayers the legislatively unintended tax savings they sought from their hollow and artificial transactions. Lord Steyn tells the story of the jurisprudential shift from form to substance in the interpretation of tax statutes and the characterization of taxpayer transactions:

On both fronts the intellectual breakthrough came in 1981 in the Ramsay case, and notably in Lord Wilberforce’s seminal speech. . . . Lord Wilberforce restated the principle of statutory construction that a subject is only taxed upon clear words. . . . To the question, “What are ‘clear words’?” he gave the answer that the court is not confined to a literal interpretation. He added: “There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded.” This sentence was critical. It marked the rejection by the House of pure literalism in the interpretation of tax statutes. . . . While Lord Tomlin’s observations in the Duke of Westminster case still point to a material

230 Arnold, “Reflections”, supra note 13 at 1, 2, and 13-19.
consideration, namely, the general liberty of the citizen to arrange his financial affairs as he thinks fit, they have ceased to be canonical as to the consequence of a tax avoidance scheme. Indeed, as Lord Diplock observed, Lord Tomlin's observations tell us little or nothing as to what method of ordering one's affairs would be recognized by the courts as effective to lessen the tax that would otherwise be payable. . . . The new Ramsay principle was not invented on a juristic basis independent of statute. That would have been indefensible since a court has no power to amend a tax statute. The principle was developed as a matter of statutory construction. That was made clear by Lord Wilberforce in the Ramsay case and is also made clear in subsequent decisions in this line of authority. . . . The new development was not based on a linguistic analysis of the meaning of particular words in a statute. It was founded on broad purposive interpretation, giving effect to the intention of Parliament. The principle enunciated in the Ramsay case was therefore based on an orthodox form of statutory interpretation. And in asserting the power to examine the substance of a composite transaction the House of Lords was simply rejecting formalism in fiscal matters and choosing a more realistic legal analysis.\(^231\)

Therefore, purposive interpretation of the taxation statute is a rejection of the \textit{Duke of Westminster} principle of literalist construction and, in the court's view, it gives effect to the intention of parliament. In that regard, the court appears to have come to the same conclusion as Justice Hand in \textit{Gilbert}\(^232\) where he said that judges "cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities it sought to impose". Further, the Ramsay doctrine was not understood as having any extra-statutory basis but was merely an approach to tax avoidance problems that was more substantive in nature. Therefore there is no question of judicial legislation or rulemaking in usurpation of the function of parliament.

Purposive interpretation allows courts to combat tax avoidance rather than stand by as mesmerized and impotent spectators, a result that is laudable from the perspective of justice, fairness, morality, and tax policy. Moreover, a substantive approach is an affirmation of the "true judicial process" that allows for the realization of a number of salutary policy effects, as Lord Wilberforce recognized in \textit{Ramsay}:

[\textit{w}hile the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must result either in loss of tax, to the prejudice of other taxpayers, or to Parliamentary congestion, or (most likely) to both. To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting, approach which the parties themselves may have negated would be a denial rather than an affirmation of the true judicial process. In each case the facts must be established, and a legal analysis made: legislation cannot be required or even be desirable to enable the court to arrive at a conclusion which corresponds with the parties' own intentions.\(^233\)]

Therefore the tax policy justifications for the abandonment of the formalistic \textit{Duke of Westminster} doctrine are that it prevents the loss of tax, it is fair to other taxpayers, and it alleviates the parliamentary congestion presumably caused by the need for constant amendments

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\(^{231}\) McGuckian, \textit{supra} note 224 at 915-16.

\(^{232}\) See note 91, \textit{supra}.

\(^{233}\) Ramsay, \textit{supra} note 107 at 326.
to the taxation statute in order to prevent the latest tax shelter schemes and to plug the most recently discovered statutory loopholes.

If the salutary effects of purposive interpretation are as Lord Wilberforce understands them to be, what could explain the resilience of textualism in the interpretation of taxation statutes? The answer, as will be discussed more fully below, is that textualism is grounded in the liberal idea of the rule of law, which is a powerful enough ideal in the minds of both British and Canadian judges that they have tolerated much tax avoidance mischief in deference to it. The result is a Canadian tax jurisprudence that has never completely rejected the Duke of Westminster principle and consequently has never developed a robust substance over form doctrine to combat abusive tax avoidance.

4.1.2. Formalism renders Statutory Anti-Avoidance Rules Ineffective

As stifling as textualism is for the prospects of the development of a judicial substance over form doctrine, it is tempting to believe that textualism may support the view that a statutorily codified anti-abuse rule mandating a broad interpretation of the ITA would have to be accepted by textualist judges. However, if the Canadian experience with the statutory GAAR is taken as a guide, statutory anti-abuse rules will not be meaningfully applied by a court steeped in formalism. In its first application of the GAAR, the Supreme Court of Canada preferred form over substance and gave an interpretation to the capital cost allowance provisions that was, in effect, a narrow textualist reading. From the perspective of American commentators, the Canadian result is not surprising. American commentators have resisted the suggestion made by some to codify existing American judicial doctrines, concerned that if the revenue authorities are compelled to rely on rigid and fixed statutory language, those bent on tax avoidance will simply

236 Canada Trustco, supra note 153.
have another opportunity to find new loopholes and unearth more avoidance opportunities.\textsuperscript{237} That concern seems to have been realized in Canada.

The GAAR was introduced in response the Supreme Court’s rejection of the business purpose test in \textit{Stubart};\textsuperscript{238} and the Supreme Court’s remarkable fidelity to the \textit{Duke of Westminster} principle.\textsuperscript{239} As discussed above, the \textit{Duke of Westminster} principle calls for strict interpretation of the taxation statute which is incompatible with the substantive approach to statutory interpretation mandated by the GAAR.\textsuperscript{240} However, rather than completely reject literalism, the Supreme Court of Canada’s decision in \textit{Canada Trustco} makes it clear that the GAAR did not do away with the \textit{Duke of Westminster} principle but at most “attenuated” it.\textsuperscript{241} The court went further and noted that notwithstanding the GAAR the ITA remains “an instrument dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation.”\textsuperscript{242} Just prior to this statement, the court noted that “the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation. Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.”\textsuperscript{243} Thus it appears that textualism will continue to be the dominant Canadian approach to the interpretation of tax statutes, or at least the interpretation of those provisions that are detailed, explicit, and dictating specific consequences. However, as noted by the court, those are the kinds of provisions that dominate the Act.\textsuperscript{244}

\begin{flushright}
\textsuperscript{238} See note 53, supra.
\textsuperscript{239} Arnold, “Reflections”, supra note 13 at 30-31.
\textsuperscript{240} Ibid. at 31 (“Following this analysis, the impact of the general anti-avoidance rule is largely the same as a purposive approach to statutory interpretation with respect to tax avoidance transactions.”).
\textsuperscript{241} \textit{Canada Trustco}, supra note 153 at paragraph 13 (“To the extent that the GAAR constitutes a “provision to the contrary” as discussed in \textit{Shell} (at paragraph 45), the Duke of Westminster principle and the emphasis on textual interpretation may be attenuated.”)
\textsuperscript{242} Ibid.
\textsuperscript{243} Ibid., at paragraph 11.
\textsuperscript{244} Note that David Duff is of the view that, although one may conclude that the decision reaffirms the plain meaning approach to statutory interpretation, that view is probably mistaken in light of the following passage from paragraph 47 of the decision, which Professor Duff views as a more pragmatic approach to interpretation:

\begin{quote}
Even where the meaning of particular provisions may not appear to be ambiguous at first glance, statutory context and purpose may reveal or resolve latent ambiguities. “After all, language can never be interpreted independently of its context, and legislative purpose is part of the context. It would seem to follow that consideration of legislative purpose may not only resolve patent ambiguity but may, on occasion, reveal ambiguity in apparently plain language.
\end{quote}
\end{flushright}
Therefore, to take the court’s reasoning to its logical conclusion, formalistic statutory interpretation will dominate in tax cases. Unfortunately, the doctrinal adjustment of the rejection of literalism that was recognized by the House of Lords as necessary for the judicial prevention of abusive tax avoidance was not made by the Supreme Court of Canada. For example, in describing the doctrinal changes that lead to substance over form in the UK, Lord Steyn (see quotation, supra) quoted the seminal speech of Lord Wilberforce from Ramsay where Lord Wilberforce said that “[t]here may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded.” According to Lord Steyn, “[t]his sentence was critical.” In contrast with the House of Lord’s willingness to make critical conceptual adjustments, the Supreme Court of Canada explicitly refused to do the same, even in a GAAR case. For example, in Canada Trustco the Supreme Court of Canada rejected the Federal Court of Appeal’s interpretation of the GAAR (that was in line with Lord Wilberforce’s critical sentence) as requiring an analysis of whether “there was an abuse of any policy of the Act read as a whole”:

The Courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions in issue. First, such a search is incompatible with the roles of reviewing judges. The Income Tax Act is a compendium of highly detailed and often complex provisions. To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the Income Tax Act would inappropriately place the formulation of tax policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped.  

This passage effectively prevents the court from approaching the interpretation and application of the ITA on the assumption that it is a policy of the Act read as a whole that it was intended to apply to transactions with real economic substance.

The result is an incompatible co-existence between the GAAR and the Duke of Westminster principle. As Brian Arnold has remarked, the GAAR - a provision that looks to the purpose of the a transaction and the purpose of the particular statutory provision - is completely

However, the resort to legislative purpose to resolve ambiguity has always been part of the plain meaning approach. For example, the Supreme Court has stated in a number of cases (see Friesen v. The Queen, [1995] 2 CTC 369 (SCC)) that if the words of the provision in question were clear and unambiguous, they must simply be applied without regard to the purpose of the provision. For criticism of the Supreme Court’s comments on statutory interpretation see Arnold, “Confusion Worse Confounded”, supra note 151 at 177-179.  

Canada Trustco, supra note 53 at paragraph 41.
inconsistent with the *Duke of Westminster* principle and if the Supreme Court of Canada fails to recognize that incompatibility, the GAAR is likely to be misconstrued.\footnote{Arnold, "Reflections", supra note 13 at 30.} Unfortunately, this is exactly what the Supreme Court of Canada did in *Canada Trustco*. It is inexplicable that the Supreme Court of Canada should attempt to reconcile the GAAR with the *Duke of Westminster* principle, as the two are polar opposites. However, given the judicial hostility to the GAAR it is perhaps not surprising.\footnote{See discussion, infra.} The GAAR and the *Duke of Westminster* represent irreconcilable substantive and textualist approaches, respectively, to statutory interpretation.

The problematic co-existence of the *Duke of Westminster* with the GAAR has resulted in a confusing and incoherent approach to the GAAR.\footnote{For a thorough discussion of the problems and confusion of the *Canada Trustco* and *Matthew* decisions see Li, "Economic Substance", supra note 153; and Arnold, "Confusion Worse Confounded", supra note 151.} The endurance of the *Duke of Westminster* appears to have distorted the court’s reasoning as it remains attracted to formalistic textualism even when attempting apply the GAAR, a provision that was enacted to prompt courts to undertake a substantive approach. This strange “oil and water” reasoning brings into the GAAR context a Supreme Court curiosity that was evident in its tax avoidance decisions from the 1990s where it would nominally adopt the purposive “modern approach”\footnote{See Ruth Sullivan, *Driedger on the Construction of Statutes*, 3rd ed. (Toronto: Butterworths, 1994) at 131-135.} to statutory interpretation but then undertake a textualist or literal interpretation of the Act. Brian Arnold summarizes the incoherence well:

> As argued earlier, the *Duke of Westminster* principle is tenable only in conjunction with the strict approach to statutory construction. Thus, it is not surprising to me that, at a time when the Supreme Court has rejected the economic realities doctrine and reaffirmed its adherence to the *Duke of Westminster* principle, it has had enormous difficulty living comfortably with the modern approach to statutory interpretation with its emphasis on legislative purpose. The court’s continuing obsession with plain meaning—both in terms of relabeling the modern rule as the “plain meaning rule” or the “modern plain meaning rule” and in suggesting that where statutory language is clear and unambiguous, it should just be applied without any need for interpretation—is clear evidence to me of the court’s discomfort with a more purposive approach to statutory interpretation, at least with respect to taxation statutes.\footnote{Arnold, "Reflections", supra note 13 at 28.}

The disjunction in the court’s reasoning and its discomfort with purposive interpretation survives in *Canada Trustco* where the court makes the following comments:

> As a result of the Duke of Westminster principle (*Commissioners of Inland Revenue v. Duke of Westminster*, [1936] A.C. 1 (H.L.)) that taxpayers are entitled to arrange their affairs to minimize the amount of tax payable, Canadian tax legislation received a strict interpretation in an era of more literal...
statutory interpretation than the present. There is no doubt today that all statutes, including the Act, must be interpreted in a textual, contextual and purposive way. However, the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation. Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.

The court seems to say that all statutes must be interpreted purposively but then contradicts that proposition by stating that the ITA is different and should receive a largely textual reading. Further, in discussing the proper interpretive approach under the GAAR, the court relies on a passage from Hogg and Magee's *Principles of Canadian Income Tax Law*, which it has relied on in many of its formalistic pre-GAAR decisions beginning with *Friesen*\(^\text{251}\) in 1995, where the authors argue that "[i]t would introduce intolerable uncertainty into the ITA if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and purpose of a provision." The content of the latter passage recalls the language and philosophical justifications for textualism, which are completely inconsistent with the GAAR. Whatever is the best way of understanding *Canada Trustco*, the resulting "textual, contextual and purposive" interpretation that the court ostensibly undertook still led it to prefer the legal form of a transaction to its economic substance for tax purposes. Therefore, while the House of Lords recognized in *Ramsay* that the Duke of Westminster principle is inconsistent with purposive interpretation, the Supreme Court of Canada did not make the same connection and remained formalistic in its tax jurisprudence even in a case where the GAAR was engaged. As a result, the statutory GAAR, aimed at abusive tax shelters, did almost nothing to change judicial outcomes which, before and after the GAAR, were grounded in highly formalistic reasons resulting in the judicial approval of tax avoidance schemes.

The Supreme Court’s GAAR analysis puts Canadian jurisprudence in almost exactly the same position it was in as a result of its decision in *Stubart* – the very decision that prompted parliament to enact the GAAR. Indeed, the *Stubart* criteria, which called for a plain reading of the provisions of the ITA in the context of its object and spirit is essentially the same as the textual, contextual and purposive analysis having regard to the object and spirit of the Act that the Supreme Court formulated in *Canada Trustco*.\(^\text{252}\) Therefore, notwithstanding the GAAR, twenty years after the *Stubart* decision, Canadian tax jurisprudence has come full circle to a

\(^{251}\) See note 185, supra.

\(^{252}\) Inness et al., *The Essential GAAR*, supra note 148 at 5.
focus on the text of the relevant provisions read in context and having regard to their object and spirit.\textsuperscript{253} The necessary conclusion is that the GAAR has been rendered essentially meaningless.

The startling ineffectiveness of the GAAR is due largely to the Supreme Court’s rejection of economic substance as a component of the analysis mandated by the GAAR.\textsuperscript{254} In many ways the Supreme Court’s analysis of the concept of economic substance or economic realities is “the most disappointing aspect of its decisions” in Canada Trustco and Matthew.\textsuperscript{255} With respect to the role to be played in the GAAR analysis by the economic substance of transactions, the technical notes which accompanied the GAAR when it was introduced in parliament said:

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.\textsuperscript{256}

However the Supreme Court all but rejected the role of economic substance in the GAAR analysis by holding that:

While the “economic substance” of the transaction may be relevant at various stages of the [GAAR] analysis, this expression has little meaning in isolation from the proper interpretation of specific provisions of the Act.\textsuperscript{257}

Notwithstanding the reference to economic substance in the explanatory notes, the court interprets them in a “perverse” way that renders economic substance meaningless in the context of the GAAR analysis.\textsuperscript{258} The court interprets the explanatory notes as meaning “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 on for the tax benefit”.\textsuperscript{259} This allows the court to conclude that it “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.”\textsuperscript{260} Therefore, unless the provision the taxpayer relies on refers to economic substance, the lack of economic substance in the taxpayer’s transactions cannot form the foundation for a finding that the provision relied upon was misused.

\textsuperscript{253} Ibid.
\textsuperscript{254} Arnold, “Confusion Worse Confounded”, supra note 151 at 192.
\textsuperscript{255} Ibid.
\textsuperscript{256} Canada, Department of Finance, Explanatory Notes to Legislation Relating to Income Tax (Ottawa: Department of Finance, 1988), clause 186.
\textsuperscript{257} Canada Trustco, supra note 153 at paragraph 16.
\textsuperscript{258} Ibid.
\textsuperscript{259} Ibid, “Confusion Worse Confounded”, supra note 151 at 192.
\textsuperscript{260} Canada Trustco, supra note 153 at paragraph 56.
\textsuperscript{60} Ibid. at paragraph 60.
or abused and, in the court’s view, the GAAR does not go so far as to allow the court to impose an economic substance requirement.\textsuperscript{261} Thus, on the facts of \textit{Canada Trustco}, the CCA provisions of the act which allow for a deduction for depreciation based on the cost of an asset; "cost" means "legal cost" not economic cost and therefore economic substance was irrelevant in the GAAR analysis of the taxpayer’s transactions.

But that is not all, for even if a provision of the Act refers to economic substance (and very few do), lack of economic substance alone will not be enough to meet the misuse and abuse test under GAAR. The fact that the transactions in issue were motivated by some non-tax purpose or were purely tax motivated is merely something that courts may consider as part of the GAAR analysis. However, any such finding of fact will not, in and of itself, establish abusive tax avoidance. For the court, the central question is the proper interpretation of the statutory provisions at issue which may stipulate that the tax benefit can only be conferred in respect of transactions that have a non-tax purpose such as business, family or other economically substantive purpose. The absence of a substantive non-tax purpose may, in the court’s analysis be a relevant factor that goes to the question of whether the statutory provisions have been abused but there is no absolute requirement in that regard.\textsuperscript{262} If lack of economic substance does not in and of itself establish abuse, the court does not say what else is necessary and even when the court articulates its test for abuse, it fails to provide any clear guidance.\textsuperscript{263} The court formulates the abuse test as follows:

\begin{quote}
[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.\textsuperscript{264}
\end{quote}

The court refers to relationships or transactions that “lack a proper basis,” but fails to provide any standard that can be applied to determine abuse; the court simply restates the issue without giving any indication of when relationships will have a “proper basis.”\textsuperscript{265} As to what will likely satisfy the test, Brian Arnold offers the bleak assessment that, given the Supreme Court’s rigid adherence to formalism, the abuse test will be easily satisfied for if the transaction is legally

\begin{footnotes}
\item[261] Arnold, “Confusion Worse Confounded”, \textit{supra} note 151 at 192.
\item[262] \textit{Canada Trustco}, \textit{supra} note 153 at paragraph 58.
\item[263] Arnold, “Confusion Worse Confounded”, \textit{supra} note 151 at 193.
\item[264] \textit{Canada Trustco}, \textit{supra} note 153 at paragraph 60.
\item[265] Arnold, “Confusion Worse Confounded”, \textit{supra} note 151 at 193.
\end{footnotes}
effective and not a sham, and it complies with the literal requirements of the relevant provisions, it will not be considered abusive.\textsuperscript{266} Therefore, the GAAR will likely do little to alter the traditional Anglo-Canadian approach to the problem of form and substance in tax law, as transactions that are legally effective and not found to be shams will pass judicial scrutiny, as was the case before the enactment of the GAAR. The consequence of the irrelevancy of economic substance in the GAAR analysis is obvious if we consider the implications of \textit{Canada Trustco}: it is very unlikely that the GAAR can ever apply to transactions that abuse the provisions of the ITA.\textsuperscript{267} The court has, therefore, unduly restricted a GAAR that parliament intended to have broad application and, notwithstanding the existence of the GAAR, the “court’s rigid adherence to legal form has been taken to a new level.”\textsuperscript{268} Another stark implication of the result in \textit{Canada Trustco} is that for a fee corporations involved in leasing are able to pay tax on a voluntary basis.\textsuperscript{269} Therefore, it appears that the Anglo-Canadian tradition of textual statutory interpretation and an adherence to the legal form of transactions has endured in spite of the GAAR and it seems that the GAAR is likely to have little impact unless economic substance is a meaningful part of the test for what constitutes an abusive transaction.

In the light of the foregoing analysis, the tax policy consequences of formalistic jurisprudence are obvious. Neither judicial nor statutory anti-avoidance rules can survive in a jurisprudential environment where the formalistic \textit{Duke of Westminster} principle continues to operate. The unhappy consequence is that formalism creates a gap in lawmaking where judges steeped in a formalistic jurisprudence will not develop standards, doctrines or approaches to combat abusive tax avoidance unless there is a statutory provision compelling them to take on such a role, but when parliament enacts such a statutory provision, the same formalistic tradition prevents the provision from having meaningful effect.

\textsuperscript{266} Ibid.
\textsuperscript{267} Ibid. at 201.
\textsuperscript{268} Ibid. at 201-202.
\textsuperscript{269} Ibid. at 202.
4.2. THE POLITICAL IMPLICATIONS OF FORMALISM

4.2.1. The Rule of Law Justifications for Formalism in Statutory Interpretation

The tension between form and substance in adjudication is often embodied in the idea of the rule of law where the tension is cast in terms of the rule of laws enacted by an elected legislature and the perceived discretion of individual judges to make decisions in circumstances not explicitly and literally anticipated in enacted laws and statues. The tension is ancient, going back at least to Aristotle, who referred to it in his Politics:

Rightly constituted laws should be the final sovereign; and personal rule, whether it be exercised by a single person or a body of persons, should be sovereign only in those matters on which law is unable, owing to the difficulty of framing general rules for all contingencies, to make an exact pronouncement.  

In each of the United States, the UK and Canada rule of law justifications for formalism are often enlisted in support of a formalistic approach to statutory interpretation which has a long history and is deeply entrenched in Canadian and UK jurisprudence. Although, this study of form and substance in tax jurisprudence has identified two manifestations of the problem – statutory interpretation and the characterization of taxpayer transactions – this section on the political implications of formalism will focus on statutory interpretation alone. This is because, as discussed above, formalism in the characterization of taxpayer transactions is the corollary of formalism in statutory interpretation and, as the House of Lords recognized in Ramsay, the latter leads to the former.

In American jurisprudence, textualism is a relatively recent movement and it stands in obvious opposition to substantive doctrines like the business purpose test that would not have been developed in an era of formalistic jurisprudence and perhaps may not survive in a jurisprudence that takes a textualist approach to statutory interpretation. Because of its relatively recent arrival in the United States, which has always been a more substantive jurisdiction than the UK, textualism has elicited a heightened awareness and lively critique among American

legal scholars who have written about it extensively. Many American scholars have been
galvanized either in support of or in opposition to textualism by the decisions of United States
Supreme Court Justice Antonin Scalia, who is perhaps the leading exponent of what is called the
“new textualism”\(^\text{272}\) in the United States. His reasons for championing textualism are explicitly
-founded on the liberal idea of the rule of law.\(^\text{273}\) Justice Scalia signaled the arrival of American
textualism in his “jarring concurring opinion”\(^\text{274}\) in *Immigration and Naturalization Service v.
Cardoza-Fonseca* in which he refused to join the majority on the basis that any resort to
legislative history was irrelevant:

> Although it is true that the Court in recent times has expressed approval of this doctrine [that
> legislative history can sometimes trump plain meaning], that is to my mind an ill-advised
> deviation from the venerable principle that if the language of a statute is clear, that language must
> be given effect — at least in the absence of a patent absurdity.\(^\text{275}\)

Under a textualist approach as it is understood in America, judges should not look for the
subjective or actual intent of the legislature but only the “objectified” intent—the words of the
enactment — which is the law that is available to citizens and to which they look when planning
their affairs.\(^\text{276}\) Therefore, according to the textualist view, it neither makes sense nor is it fair to
inquire into what was intended rather than what was enacted, for “men may intend what they
will; but it is only the laws that they enact that bind us.”\(^\text{277}\) In fact, supporters argue, it is
textualism that ensures respect for the rule of law for it makes a nation a government of laws, not

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\(^\text{272}\) The phrase “new textualism” was first used in William N. Eskridge, Jr., “The New Textualism” (1990) 37 UCLA
L. Rev. 621 [Eskridge, “New Textualism”] to describe U.S. Supreme Court Justice Scalia’s approach to statutory
Chi. L. Rev. 1175 [Scalia, “The Rule of Law”]. The new textualism is also supported by the writing of F.H.
Easterbrook justified a highly literal approach to statutory interpretation with a skepticism of how the legislative
process works; this corresponds with a preference for private ordering.


1997), at 17.

\(^\text{277}\) Ibid.
of men. Of course, it is an underlying theme of this paper that textualism is subject to the criticism that it is formalistic and that it detaches law from its underlying policies and from the real world in which and with regard to which statute law is drafted. However, Justice Scalia’s response is, “[o]f course it’s formalistic! The rule of law is about form.”

In British tax cases decided before Ramsay, judges echoed Justice Scalia’s reasons for adopting a textualist approach. The passage from Lord Simon of Glaisdale cited in chapter 3 demonstrates the British aversion to “rule by a person or body of persons” even if that person is a duly appointed judge working with all the constraints of jurisprudence, precedent, legislative oversight, and constitutional restrictions.

True its British pedigree Canadian jurisprudence has, since the late 1990s and before Stubart, employed similar justifications for its formalistic approach. For example, the decisions of the Supreme Court of Canada, beginning in the late 1990s when formalistic statutory interpretation gained prominence, justify formalism with appeals to values commonly associated with the rule of law and the closely related justification of legislative supremacy. For example, in Ludmer Justice Iacobucci stated that courts should be “mindful of their role as distinct from Parliament” and that the legislature rather than the courts is responsible for “the promulgation of new rules of tax law.” In Antosko he stated that it is for the legislature, not the courts, to conduct “a normative assessment of the consequences of the application of a given provision”.

The enactment of the GAAR did nothing to alter the court’s trepidation in changing the direction of its tax jurisprudence through the promulgation of new approaches, doctrines, rules, or standards. For example, in Canada Trustco the Supreme Court of Canada rejected the Federal Court of Appeal’s interpretation of the GAAR as requiring an analysis of whether “there was an abuse of any policy of the Act read as a whole” by using the separation of powers and judicial

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278 Ibid.
279 Ibid. at 25.
280 See note74, supra.
282 Ibid. paragraph 38.
283 Ibid.
284 See note 183, supra.
285 Ibid. at paragraph 38.
The court was evidently afraid of venturing into the "formulation of tax policy" which was "a task to which [judges] are unaccustomed and for which they are not equipped". In other words, the court cannot look to the policy of the ITA read as a whole to hold that it was intended to apply to transactions with real economic substance. However, it is not all clear that such an approach would constitute a legislative formulation of tax policy. As Lord Wilberforce recognized in Ramsay, such an approach is properly understood as a matter of statutory construction and is fundamentally a judicial rather than a legislative process.

Another favourite justification of the Supreme Court of Canada is to rely on the principles of legal certainty and individual liberty, which are closely connected to the liberal notion of the rule of law. In Duha Printers, Justice Iacobucci stated that certain and predictable rules are to be preferred in tax law because taxpayers rely on the statute when they plan their affairs. Similarly, in Canada Trustco, the Supreme Court of Canada again relied emphatically on the rule of law values of certainty and predictability. However, this is also problematic, as the court fails to provide any analysis or authority to support the proposition that only literal interpretation can uphold the rule of law values of certainty and predictability. The court rests content with simply asserting the proposition (six times in Canada Trustco) as self-evident. Far from being self evident, the proposition has been challenged in the United States where Stanley Surrey has argued that the judicial use of a general standard of "prevention of tax avoidance" in interpreting the tax code has rendered the code more certain.

The problem with rule of law justifications of textualism and formalism generally is that they implicitly deny that statutory provisions interpreted substantively and substantive standards such as the Ramsay doctrine and the business purpose test are rules of law or at least that they are rules of equal status to highly formal rules. To the contrary, it is obvious that substantive rules are still rules of law and their use in a legal system does not compromise the notion of the rule of law. It that were so, then most of constitutional law, which is composed of broad standards that

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286 Canada Trustco, supra note 153 at paragraphs 38-41.
287 Ibid. at paragraph 41.
288 See discussion note 233, supra.
289 Duff, "Justice Iacobucci", supra note 38 at 569. See also Phillips, "The Rule of Law", supra note 234.
290 Arnold, "Confusion Worse Confounded", supra note 151 at 178.
gives judges considerable interpretive leeway is an affront to the rule of law. The same would be true of tort law or any legal principle that uses concepts like intention, reasonableness, foreseeability, unconscionability, or due diligence. In most areas of law both formal and substantive rules comprise the legal system. There is no reason to eliminate one type of rule form tax jurisprudence. To the contrary, there is a great need for substantive standards in tax law.292

4.2.2. Despite appeals to democratic values, textualism tends to be undemocratic and elitist

While the idea of the rule of law may be the principal justification for textualism, other democratic values are thought to be defended by textualism. For example, textualism appeals to democratic values such as majoritarianism in that that rules made by courts can be effected by a single litigant, while rules promulgated by the legislature usually have broader political support or at least are legitimized by the institution of representative democracy.293 Moreover, some commentators believe that if textualism enables the courts to force the legislature to speak clearly in statutes the legislature will have to become more “republican” in the sense that the legislature will be forced to be more deliberative and to debate among many viewpoints and to be more “transparent” in the sense that it will have to make plain to its constituents the rules that it has enacted to govern them.294

The problem with the “democratic values” justifications for textualism is that they are too narrow and theoretical. At least in the context of tax law, they do not acknowledge that formalistic jurisprudence privileges the rights of well-advised businesspeople over the rights of the great mass of taxpayers. In other words, in practice formalistic jurisprudence tends to be elitist rather than democratic. Formalism ensures that certain individuals are able to cast their fiscal burden on others rather than upholding the much more democratic values of fairness and equality that are embodied in the idea that everyone should pay their fair share of the national expenditure. These are the findings of Robert Stevens, who examined the history of British tax

292 See chapter 5.
293 See also Easterbrook, “Statutes Domains”, supra note 272 at 536.
jurisprudence in the areas of statutory interpretation and anti-avoidance doctrines within a
broader analysis of the decisions of the House of Lords. Stevens argues that class interest in
peace time (in favour of the higher classes) and communitarian values in times of war influenced
the tax avoidance decisions of the House. According to Stevens, the British courts did not treat
tax matters differently from other legal matters in the nineteenth century. However, a progressive
income tax was introduced in the twentieth century and the House of Lords took a formalistic
approach to the interpretation of the tax statute that allowed taxpayers to engage in tax avoidance
in order to protect the incomes of the “established sections of society” Things changed during
World War II when some of the Lords adopted a “patriotic” attitude to tax avoidance according
to which all citizens were “under an obligation to pay a fair share” of their taxes. However,
once the war ended, the Law Lords reverted to the old formalism. Stevens’ study suggests that,
far from being democratic and implementing the rule of law, formalism is political and elitist.
This is not surprising, as tax avoidance is the privilege of relatively well-off taxpayers who earn
income from business. For employees, tax is deducted at source and there are few opportunities
for tax avoidance. It has never been argued (and it cannot seriously be argued) that the resulting
inequality in the administration of the ITA is Parliament’s intent or is a result that embodies the
values of a democratic society.

4.2.3. Textualism Represents an Incongruent Libertarian Approach to the ITA

To better understand the implications of textualism, it is necessary to examine the
relationship between judges and legislation. Of particular significance is the relationship
between judges and the regulatory statutes that were enacted beginning in the early twentieth
century. These statutes enacted protections for workers, consumers and others who found
themselves in a less powerful position in relation to relatively more dominant entities in various
spheres of life by establishing a public law system of rights, obligations and protections that was
laid over the pre-existing private law regimes of property, contract and tort law which had
always operated in a laissez faire environment of private ordering. As such, the new

296 Ibid. at 170-176.
297 Ibid. at 394.
298 Ibid. See also Sunstein, “Interpreting Statues”, supra note 294 at 408.
regulatory statutes disrupted the old, coherent legal order and consequently judges were hostile towards them and approached them in a manner that constrained their application. One example comes from United States Supreme Court Justice Cardozo who remarked that, “[t]he truth is that many of us, bred in common law traditions, view statutes with a distrust which we may deplore, but not deny.”299 Judges saw “statutory protections of workers, consumers, and others as unprincipled interest-group transfers supported by theories that were at best obscure and often disingenuous.”300 By contrast, judge-made doctrines of property, contract, and tort seemed to create a system with integrity and coherence.301 During this period, judges approached the interpretation of regulatory statutes with the assumption that they should be construed narrowly to harmonize them as much as possible with private markets and private rights.302 Although, strictly speaking, taxation statutes are not regulatory in nature, the British tax jurisprudence of the late nineteenth century and both the British and Canadian jurisprudence of most of the twentieth century unmistakably display the hostility that is associated with the advent of regulatory statutes.303 It is apparent that judges in the early twentieth century were acting according to Dworkin’s law as integrity theory in that they sought to harmonize the new regulatory statutes with the integral and coherent private law regimes of property, tort, and contract. However, their mistake was that they were blind to the altruistic and collectivist political morality that formed the basis of those statutes. Judges misinterpreted the legal record of the community as expressing only the individualistic, private rights based political morality of private markets in a time where the statutory expressions of the legislature disclosed that the community demanded far more from than that from the law.

Moving from the past to the present, Cass Sunstein sees the contemporary problem of textualist statutory interpretation as being rooted in the in the judicial hostility towards regulatory statues that began in the early part of the twentieth century.304 The contemporary version of the old hostility is the assumption in favour of private ordering which states that citizens are free to

300 Sunstein, “Interpreting Statutes”, supra note 294 at 408.
301 Ibid.
302 Ibid.
303 See chapter 3, supra .
conduct their affairs free of governmental interference, a principle that finds its way into adjudication through formalism in statutory interpretation.\textsuperscript{305}

A contemporary example from tax law of the old judicial hostility is found the Canadian decisions that have considered the GAAR. Canadian judges displayed a remarkable suspicion of the GAAR, which was a provision that, more than any other, threatened the ability of taxpayers to avoid their tax liabilities through private ordering. For example, associate Chief Justice Bowman of the Tax Court, as he then was, was not enthusiastic about embracing the GAAR:

Section 245 is an extreme sanction. It should not be used routinely every time the Minister gets upset just because a taxpayer structures a transaction in a tax effective way, or does not structure it in a way that maximizes the tax.\textsuperscript{306}

Justice Miller referred to the GAAR as the government’s “ultimate weapon” in a passage that conveys a judicial perception of the GAAR as a violent threat to private ordering. When Justice Miller refers to the “sanctity of legal relationships” he is referring to the sanctity of private ordering and obviously ranks the need to preserve it above the need to give effect to a parliamentary enactment:

The Appellant has most deliberately relied on the sanctity of legal relationships, not to be impugned by the economic realities of a situation, in achieving his goal. . . . [W]hile GAAR may be the ultimate weapon for the government to undo such legal relationships, in this instance the application of GAAR is simply ineffective.\textsuperscript{307}

In the trial level decision in Canada Trustco, Justice Miller expressed much the same sentiment:

GAAR is not to be imposed lightly. . . . [T]his is tax legislation to be applied with utmost caution.\textsuperscript{308}

And again in the same decision, Justice Miller said the following:

[I]t should only be Parliamentarians through legislative policy, not the executive through regulatory policy, that can yield [sic] as heavy a hammer as GAAR to deny a taxpayer a tax benefit.\textsuperscript{309}

\textsuperscript{305} Ibid at 444.
\textsuperscript{307} Hill v. The Queen, [2003] 4 CTC 2548, at paragraph 63.
\textsuperscript{308} Canada Trustco, supra note 153 at paragraphs 77 and 91.
\textsuperscript{309} Ibid. at paragraph 58.
The judicial suspicion of the GAAR is not confined to the Tax Court. It has manifested itself in the Federal Court of Appeal where Justice Rothstein described the halting and timid manner in which the court would approach the GAAR:

\[\text{[t]he Court will proceed cautiously in carrying out the unusual duty imposed upon it under subsection 245(4).}\]

From these “prejudicial” comments it is apparent that some judges view the GAAR with considerable suspicion and conceive of their role in the adjudication of tax cases as one of limiting its application and as a restraint on parliament and its power to control abusive tax avoidance. A judicial approach to the GAAR that is consistent with the democratic separation of powers would not seek to limit or restrain the legislature but would seek to give its enactments full force and would recognize that following the Supreme Court of Canada’s rejection of the business purpose test in *Stubart*, Parliament had no alternative but to enact a legislative GAAR to prevent abusive tax avoidance.

### 4.2.4. Formalism runs counter to the collectivist and altruistic foundations of the ITA

Another facet of libertarianism is individualism and one of the reasons for the judicial hostility towards the regulatory statutes of the early twentieth century is the incongruence of their collectivist and altruistic philosophical foundations with the very different individualistic common law regimes of tort, contract and property. Individualism is the belief in the legitimacy of self-interested conduct and that one should be willing to respect the rules that maintain the

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310 *OSFC Holdings Ltd. v. The Queen*, [2001] 4 CTC 82 (F.C.A.) at paragraph 69.
312 Ibid. at 492 (Making the point that in addition to rejecting the business purpose test, the Supreme Court of Canada has “insisted on a literal or plain meaning approach to the interpretation of tax legislation. It has insisted on strict adherence to the legal form of transactions and consistently rejected any reference to economic realities in applying the provisions of the Act. Specific anti-avoidance rules are of limited effectiveness. Better-designed and better-drafted legislation is a desirable goal; but even if it is achievable to some degree, it cannot ever be an adequate response to the problem of tax avoidance. So what is Parliament to do? It did the only reasonable thing left for it to do—enact a general anti-avoidance rule.”)
market and make it possible for self-interested persons to co-exist.\textsuperscript{313} Individualism also implies a conviction that persons are entitled to enjoy the benefits of their efforts without an obligation to share them or sacrifice them in the interests of others.\textsuperscript{314} Individualism provides the foundation for the fundamental legal regimes of contract, criminal law, tort, and property.\textsuperscript{315} The counter ethic to individualism is altruism, which is the belief that it is best not engage in self-interested conduct at the expense of the interests of others, preferring sacrifice, sharing, and mercy.\textsuperscript{316} The private law of property, torts and contracts as well as the discourses of the legal system are dominated by individualism to the extent that law is about the definition and enforcement of rights asserted and enjoyed by individuals. In other words, justice in private law is about the respect for rights, never the performance of an altruistic duty and the state acts through private law only to protect rights, not to enforce morality.\textsuperscript{317}

In contrast to the private law regimes of contract, tort and property, relatively more recent statutory regimes such as the ITA, social security and minimum wage legislation, and environmental protection laws exist that embody communitarian, collectivist, and altruistic values. The collectivist and communitarian foundations of a comprehensive statutory income tax regime are obvious: the ITA calls upon most citizens, if their income meets the statutory threshold, to contribute their fair share to the national expenditure. Even more than collectivism and communitarianism, “the progressive income tax [seems] to have an unmistakable altruistic basis” requiring those with a greater ability to pay to contribute a higher percentage of their income and a greater absolute amount to the expenses of the state.\textsuperscript{318} In addition, there are numerous programs such as the child tax benefit which seek to implement some form of income redistribution through the ITA. Therefore, one way to view altruistic statutory regimes such as the ITA is that they are “designed to force people with power to have due regard for the interests of others.”\textsuperscript{319}

\textsuperscript{313} Duncan Kennedy, “Form and Substance in Private Law Adjudication” (1976) 89 Harv. L. Rev. 1695 at 1713 [Kennedy, “Form and Substance”].
\textsuperscript{314} Ibid.
\textsuperscript{315} Ibid.
\textsuperscript{316} Ibid at 1717.
\textsuperscript{317} Ibid.
\textsuperscript{318} Ibid at 1719.
\textsuperscript{319} Ibid.
The fact that relatively recent altruistic statutory regimes were enacted against an individualistic background of private law rules that have a largely non-existent altruistic content has created a problem in contemporary jurisprudence. A textualist approach to the construction of statutes, as it is based upon the individualistic idea of the liberal rule of law, may be a confused application of the political foundations for one set of legal norms (contract, tort and property) to a statutory regime which is founded on incompatible communitarian and altruistic political foundations. Similarly, a formalistic approach to taxpayer transactions uses rule of law justifications to frustrate the communitarian and altruistic nature of the ITA by privileging the private legal relationships created by the taxpayer to “protect” the subject’s property from the clutches of the more altruistic public law of taxation. To be specific, the Duke of Westminster right to avoid taxes and the treatment of taxation statutes as penal in nature both involve an incoherent conflation of the individualistic mode of private law rules with a statute that has a contrary altruistic and collectivist political foundation and therefore demands a judicial approach that recognizes that foundation.

This is the point made by Duncan Kennedy when he recognizes that the altruistic statutory regimes that were superimposed upon the original individualist legal order were interpreted by the courts in a way that subjected them to a thorough individualist interpretation that “might have constricted them to the point of de facto nullification.” 320 Thus, there is a tension between individualism and altruism with each of the conflicting visions claiming “universal relevance but … unable to establish hegemony anywhere.” 321 The tension is nowhere more evident than in Canadian tax jurisprudence, where the vacillation between form and substance reveals the tension between the individualism of the Duke of Westminster principle and the altruism of a progressive taxation regime of general application. Chapter 3 has shown that the ideas that underlie form and substance are varieties of individualism (such as rule of law values) and altruism (such as “everyone should pay their fair share”), respectively. Therefore, tax jurisprudence can be seen as a particular instance of the wider public law problem that it “has not completely outgrown the understandings that underlay the initial period of judicial

320 Ibid at 1737.
321 Ibid.
antagonism." The judicial constraint of public law statutes and the old antagonisms are revived in contemporary arguments that the courts should "indulge a presumption in favor of private ordering and should interpret regulatory statutes so as to intrude minimally on the private market." Although private ordering conforms to a libertarian political order, in the context of the ITA the idea that tax liabilities can be determined by the private ordering of the taxpayer subverts the rule of law.

4.2.5. Formalistic jurisprudence subverts Parliament

The preceding discussion, at various points, has touched on the idea that the individualistic formalism of Canadian tax jurisprudence is contrary to the political and philosophical foundations of the ITA and contrary to parliament's intent. The judicial reception of the GAAR is a specific example of how judges sometimes see their role as one of limiting the application of the enactments of parliament. In fact, it has been recognized by legal scholars that one of the functions of textualism in statutory interpretation is to limit the reach of the legislature. Such a judicial approach in cases involving tax avoidance cannot be construed as anything other than substituting the rule of caprice for that of law, with the values of judges taking precedence over those of parliament. It must be noted that in some circumstances and with respect to certain kinds of legal problems formalistic approaches in jurisprudence completely justified and necessary. However, in tax cases involving tax avoidance schemes, textualism reduces the power of legislature by reducing the sweep of statutes to the most limited construction of their terms. Many proponents of textualism argue the opposite, that textualism increases the importance of legislature relative to courts. But the point is that both the legislature and the courts can accomplish less under a textualist regime. In other words, the effect of textualism is that it pushes the law out of areas of human activity that parliament intended should be governed or regulated by a particular statutory regime. For example, in tax cases an economic

322 Sunstein, "Interpreting Statutes", supra note 294 at 409.
323 Ibid at 410.
325 See chapter 5.
substance doctrine would provide an avenue for the revenue authority to argue that the legislature could not have intended that transactions with no economic substance or business purpose could be used to generate tax benefits. However a textualist court would not find a basis for such a doctrine in the unexpressed purpose of a provision of or the statute read as a whole. In this way, textualism leaves the revenue authority with no legal principle with which to enforce the revenue raising purpose of an income tax statute. With statutory law made rigid and narrow by formalistic jurisprudence more space is left for private ordering and market solutions to determine a taxpayer’s liabilities for tax when these should be determined by the enactments of parliament.327

While market-based solutions may be valuable to a degree in other areas of law like contract or property law,328 the consequences of textualism are problematic in a tax context where the private ordering of tax liabilities gives the absurd result of allowing taxpayers to contract out of the rule of law. Textualism allows those private actors who can afford the right advice and have ability to earn income from sources other than employment the privilege of paying tax on a voluntary basis through abusive tax shelters and avoidance schemes when no reasonable reading of the ITA suggests that there is anything voluntary about the obligations it imposes. While the ITA bestows tax benefits for activities like scientific research, there is no apparent intention in the ITA to provide a tax holiday as a reward for formalistic taxpayer ingenuity. Therefore textualism creates a situation where taxpayers who engage in abusive tax avoidance are able to justify their conduct with “a patina of legality” and are therefore empowered to go against moral norms that may otherwise constrained them. Furthermore, lawyers are ethically prevented from advising clients against abusive tax avoidance in an environment where the judiciary “elevates form over substance and requires the law to be read without regard to societal context.”329 Consequently, textualism creates a situation where the law is diverges from society’s values and textualism is unintentionally subverts the rule of law by allowing some taxpayers to pay tax voluntarily; such abuses can be productively addressed by

328 See chapter 5. Even in contract and property law, formalistic doctrines have been limited by the doctrines of good faith and unconscionability in contract law and concepts such as the constructive trust in property law where formal legal relationships and contractual terms are subject to substantive doctrines which may alter formal property rights or find a breach of contract in substance where one may not have existed in form.
altering judicial attitudes toward statutory interpretation. After all, "statutory provisions are not merely found abstractions, unreasoned and arbitrary in nature. Rather, they have a purpose. It would be a disservice to [the legislature], to taxpayers and to the government if courts did not labor, however imperfectly, to identify and implement a persuasive purpose for the provision in question." 

4.3. THE LEGAL PHILOSOPHICAL IMPLICATIONS OF TEXTUALISM

The legal philosophical implications of textualism have to do with the question of what law is. It is notoriously difficult to answer the question, "what is law?" and it has been a preoccupation of the philosophy law to formulate the most appropriate definition. The discussion that follows does not depend upon any one definition of law for a foundation. However, definitions of law from Austin and Aquinas, representatives of the two poles of positivism and natural law, respectively, provide an anchor for the analysis. Whatever definition of law is used, the relationship between law and the citizen as it is traditionally conceived - and still maintained in the law outside of tax jurisprudence - is turned on its head by formalism in tax law. Indeed, formalistic jurisprudence presents a distinctly dystopian vision of law. Under formalistic tax jurisprudence, law (in the tax context) becomes merely symbolic and becomes commodified.

4.3.1. Under Formalistic Jurisprudence Law Becomes Merely Symbolic

Austen’s theory of law is essentially that it is comprised of commands, backed by the threat of sanctions, issued by a sovereign to whom people have a habit of obedience. Austin’s conception of law conveys its governmental or regulatory character as an institution to which citizens submit and with which they comply. Apart from Austin’s visions of law as a form of

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330 Ibid.
331 Robert Thornton Smith, “Business Purpose: The Assault upon the Citadel” (1999), 53 Tax Law. 1 at 14-20 (arguing that "a theory-embedded approach to interpretation is ... not only attractive but inevitable," and proposing a “constructive purposive” interpretive theory modeled closely on the jurisprudence of Ronald Dworkin).
coercive ordering, law is in the interests of those governed by law because “[e]ffective legal rules are seen as legitimate in and of themselves; they provide for the ordering of resources and the provision of collective goods by precluding resort to non-legal principles that resulted in the very disagreements the law was meant to resolve.” Therefore, law belongs to the common good of a society. As Thomas Aquinas recognized, law is the ordinance of reason for the common good, promulgated by the person who has care of the community. Therefore, for Aquinas law is an institution that orders social interactions for the good of all.

Formalism produces a vision of law that is contrary to the notion of law an institution for the governance of citizens for the common good. Under formalistic jurisprudence, the law is not the governor of citizens but their tool or weapon with which to avoid their obligations to contribute to the public purse. Formalism also compromises law as an institution for the common good, as it allows some individuals to cast their fiscal burden on others for whom tax avoidance is not possible. Law thus becomes the advantage of the few and a commensurate burden for the many. Therefore, formalistic tax jurisprudence reverses the law. It enables law - formal legal relationships and the rules of the tax code formalistically construed - to be used to avoid the legal obligations which would otherwise be binding (the liability to tax imposed by the ITA). As Doreen McBarnet put it, “[t]hose allegedly subject to the law can turn the law upon itself and render it ineffective” and that “[d]espite the legislature and despite the enforcers, law becomes merely symbolic” [emphasis in the original].

This reversal of law into something merely symbolic is the appearance in law of the postmodern phenomenon of the simulacra – a dystopian situation where appearances and signs exist independently of any underlying reality to which they could refer. Jean Beaudrillard could have been referring to tax avoidance transactions and formalistic jurisprudence when he gave the following description of simulacra:

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If we were able to take as the finest allegory of simulation the Borges tale where the cartographers of the Empire draw up a map so detailed that it ends up exactly covering the territory (but where the decline of the Empire sees this map become frayed and finally ruined, a few shreds still discernible in the deserts - the metaphysical beauty of this ruined abstraction, bearing witness to an Imperial pride and rotting like a carcass, returning to the substance of the soil, rather than an aging double ends up being confused with the real thing) - then this fable has come full circle for us, and now has nothing but the discrete charm of second-order simulacra.

Abstraction today is no longer that of the map, the double, the mirror or the concept. Simulation is no longer that of a territory, a referential being or a substance. It is the generation by models of a real without origin or reality: a hyperreal. The territory no longer precedes the map, nor survives it. Henceforth, it is the map that precedes the territory - PRECESSION OF SIMULACRA - it is the map that engenders the territory and if we were to revive the fable today, it would be the territory whose shreds are slowly rotting across the map. It is the real, and not the map, whose vestiges subsist here and there, in the deserts which are no longer those of the Empire, but our own.  

In the substantive jurisprudence of the US and the UK, the “territory” (real commercial activity) precedes the “map” (the application of the law as the representation of real commercial activity in the form of legal concepts). The latter is the normal manner in which law relates to the world and is the manner in which, in every area of the law, law is oriented to the world. In Canadian tax jurisprudence that orientation is reversed so that the map (the creation of a tax avoidance plan through the arrangement particular legal relationships giving rise to artificial transactions with no basis in commercial reality) precedes the territory (real economic gains in the form of unintended tax benefits generated by the avoidance transaction). Tax avoidance transactions consist merely of symbols (words, concepts and legal relationships) moving around pieces of paper, detached from the real world of commercial life and business from which they were created and to which they would otherwise refer in substantive and real transactions. The judicial acceptance of such transactions through formalistic jurisprudence is an acceptance of simulacra with no substance in reality. Because these unreal forms are described in terms of legal relationships Canadian courts see fit to use them to justify the granting of real economic benefits to taxpayers by allowing the tax benefits generated by the simulacra. The process is a kind of legal ritual or alchemy where lawyers utter the correct incantations and large sums of money appear in the hands of their clients who undertook no commercial or business activity to earn that money. That law should be reduced to mere symbols unrelated to any real occurrences or consequences yet create real legal (the elimination of tax liabilities) consequences is a dysfunctional conception of law. It reduces the law to something analogous to a software code – a meaningless and ephemeral

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337 Jean Beaudrillard, Simulations (New York: Semiotext(e), 1983) at 1.
4.3.2. Formalistic Jurisprudence Commodifies Law

Rather than being merely symbolic, the law should be concrete. In the same way that the word “apple” refers to a concrete reality, the word “reorganization” refers to the reorganization of the going concern undertaken in the ordinary course of business for a business purpose.\textsuperscript{338} Similarly, in \textit{Canada Trustco}, the word “cost” should mean more than “legal cost” – it should refer to the real economic cost of the trailers. If a bystander were to ask an official at Canada Trustco how much the trailers cost the company, the official would say, “Well, technically they cost us $120 million but in reality they didn’t cost us anything.” For this reason, financial accounting takes a substance over form approach to disregard transactions with no economic substance by restating transactions in terms of their economic reality.\textsuperscript{339} Users of financial statements - investors, lenders, and other actors in the fields of finance and commerce - would quickly find themselves ruined if financial and commercial decisions were based on hollow simulacra of the kind blessed by formalistic tax jurisprudence. That an institution such as law should sanction and determine liabilities for tax on the basis of empty forms when the non-legal world of finance and commerce disregards them when transacting devalues the law and weakens its legitimacy. The role of law in society is nullified if taxpayers are able to function just beyond the reach of law in a laissez faire marketplace where those with the means are able to appropriate the law to determine for themselves what will be their level of taxation. The logical conclusion of this process is that law becomes a commodity. Like any other technology, law as a

\textsuperscript{338} \textit{Gregory, supra note 78.}

\textsuperscript{339} Philip E. Meyer, “A Framework for Understanding “Substance over Form in Accounting” (1976) 51 The Acc. Rev. 80 (noting that the Accounting Principles Board characterized “substance over form” as a basic principle in financial accounting. Statement No. 4 of that board states, “Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment. Usually the economic substance of events to be accounted for agrees with the legal form. Accountants emphasize the substantive of events rather than their form so that the information provided better reflects the economic activities represented.” Meyer makes the point that economic substance is integrated into the resulting accounting by “restating the existing transaction” or by “imputing an altogether different (set of) transaction(s) to reflect the economic substance of events and circumstances that have transpired”. See also, Graeme MacDonald, “Substance, Form and Equity in Taxation and Accounting” (1991) 54 The Mod. L. Rev. 830.
commodity is a form of intellectual property. Consequently, it is not surprising that the United States Patent Office has granted a number of patents for tax avoidance strategies.340

4.4. Conclusion

Formalistic tax jurisprudence has tax policy, political and legal philosophical implications that run counter the norms, values and political morality of the community. As such, formalism is not the best constructive interpretation of the tax jurisprudence. Substantive approaches are more in line with the community’s notions of a just and fair tax system, the political foundation of the ITA and idea of the rule law itself should play in society.

The tax policy implications of a formalistic jurisprudence are that it allows tax avoidance to flourish by preventing or abrogating judicial anti-avoidance doctrines and by preventing statutory general anti avoidance rules from being effective. Consequently, formalistic tax jurisprudence produces a gap in lawmaking where judges steeped in the formalistic tradition will not develop standards, doctrines, or approaches to combat abusive tax avoidance unless there is a statutory provision compelling them to take on such a role, but when parliament enacts such a statutory provision, the same formalistic tradition prevents the provision from having meaningful effect. The result is inequality and unfairness in the administration of the ITA.

The political implications of a formalistic jurisprudence are that its libertarian tendencies that constrain and limit the legislature, giving a preference to private ordering that inappropriately allows those with the wherewithal to engage in tax avoidance the ability to pay tax voluntarily; this amounts to a compromise of parliamentary supremacy. Although formalism is sometimes justified by democratic values, in practice formalism tends to be elitist and undemocratic. Furthermore, the collectivist and altruistic foundations of the ITA are seriously compromised by the individualistic values that form the political basis for formalistic jurisprudence.

Formalistic jurisprudence also has legal philosophical implications in that it presents a dysfunctional vision of what law is by reducing law to a hollow and merely symbolic code—a kind of commodified technology of private ordering that can be purchased by taxpayers with the requisite resources to step beyond the reach of the rule of law. Therefore, formalism produces the dysfunctional situation where law, which is the institution that is meant to govern citizens for the common good, governs them for the good of the few who are appropriately positioned for tax avoidance and to the detriment of the community as a whole.

It is not possible to find support for the implications of formalism in the larger body of Canadian law. The values of democracy, parliamentary supremacy, sharing the fiscal burden, fairness and governance for the common good are intuitively recognized as the being vital and current norms and values of the community. However, these values are seriously compromised by formalistic tax jurisprudence whereas they would be embodied in a jurisprudence that was more substantive in its approach. Therefore, because substantive approaches would make tax jurisprudence consistent with the norms and values of the community, they would bring it some way towards achieving integrity. This suggests that substantive approaches are the right answer to the form and substance problem in tax law. However, in accordance with Dworkin’s injunction, it is necessary to interpret the legal record as a whole. With that in mind, Chapter 5 moves beyond tax jurisprudence and examines the problem of form and substance in the law generally to gauge whether formalistic tax jurisprudence is integral with the greater body of law or in discord with it and whether there are any rational reasons for that discord. For tax jurisprudence to be the best it can be, it must be integral with the best principles of the greater body of law, as that body of law represents the shared values and principles of the community. Those values and principles should inform tax law so that tax jurisprudence is integral with them rather than an insular body of rules that is cut off from the shared community norms expressed in other areas of the law. If tax law is insulated from the community norms that give life to the greater body of law outside of tax, tax law is bound to be regarded as unjust, unfair and backward as any law will be if it is in discord with the norms embodied in the rest of the community’s legal principles.
5. Form and Substance beyond Tax Jurisprudence

This chapter is divided into 4 sections. Section 5.1 describes formal and substantive reasons and the manner in which they interact in the legal system to give rise to the two varieties of rules - highly formal rules and comparatively substantive standards. Section 5.2 tackles considerations relevant to the choice between highly formal rules and standards and describes the usual domains of form and substance, respectively. Section 5.2 shows that there is division of labour between highly formal rules on the one hand and more substantive standards on the other and that the two varieties of rules play different but equally critical roles in a legal system, illustrating that the choice between form and substance is not arbitrary. Rather, it reflects (or ought to reflect) the functional necessities and requirements of a legal system that seeks to achieve justice, fairness, and effectiveness. A rational legal system will (or ought to) choose a formal or substantive approach to a particular legal problem on the basis of the systemic - be they procedural, administrative or economic - requirements and limitations of that particular legal system. Section 5.3 takes the insights into form and substance that are set out in sections 5.1 and 5.2 and applies them to the form and substance problem in tax law to conclude that substantive anti-abuse standards such as a GAAR or the American business purpose and economic substance doctrines are more integral (i.e. horizontally consistent with the larger legal system) and more effective for controlling tax avoidance than are formalistic approaches such as the one that has been in vogue at the Supreme Court of Canada since the late 1990s. Section 5.4 examines the form-substance problem as it manifest itself in other areas of law, specifically, contract law, employment law, and property law. These areas law have been chosen because they are most amenable to formalistic reasoning, compared to, for example, tort and constitutional law which are dominated by substantive, standards-based reasoning. The solutions to the form and substance problem in these areas of law inform the discussion of form and substance in tax jurisprudence showing that formalistic tax jurisprudence is an exceptional phenomenon in Canadian law and that such an exceptional status is not justified.
5.1. A FRAMEWORK FOR UNDERSTANDING THE FUNCTION OF FORM AND SUBSTANCE IN A LEGAL SYSTEM

5.1.1. What do we mean by “form” and “substance” in legal reasoning?

Tax jurisprudence and jurisprudence in general is a process of applying legal reasoning to a set of facts to reach a legal decision. Within that process, reasons take the form of doctrines and principles that form the basis for the decision and these may be distributed along a continuum of highly formal rules at one end and highly substantive rules on the other. Chapter 3 surveyed the jurisprudence of the UK, USA and Canada showing that at different times and in different jurisdictions formal or substantive reasons dominated the reasoning process and drove judges to reach one conclusion, that permitted tax avoidance, or another conclusion that prevented tax avoidance.

5.1.1.1. Substantive Reasons

However, before considering formal and substantive legal rules, it is useful to begin the analysis with the raw material of both kinds of rules, what Atiyah and Summers refer to as formal and substantive reasons. Atiyah and Summers offer the following definition of formal and substantive reasons:

A substantive reason is a moral, economic, political, institutional, or other social consideration. Thus the fact that D has intentionally harmed P is a reason of substance for deciding that D ought to be required by law to pay damages to P. If the law has not yet invoked such substantive reasoning in this particular way, its incorporation into a legal rule (or other form of law) will create a new source of formal reasoning. A formal reason is a different kind of reason from a substantive reason that has not yet been incorporated in the law at hand. A formal reason is a legally authoritative reason on which judges ... are empowered or required to base a decision or action, and such a reason usually excludes from consideration, overrides, or at least diminishes the weight of, any countervailing substantive reason arising at the point of decision or action.341

Substantive reasons may be defined as based upon a moral, economic, political, institutional, or other social consideration.342 At this level, substantive reasons are not yet incorporated into positive law and a purely substantive reason cannot exist in the law.343 Therefore, the substantive reasons described are not equivalent to the substantive approaches to tax avoidance.
cases surveyed in chapter 3 because the latter clearly exist *in the law* while the former do not. Rather, at this foundational level substantive reasons are the ideas that form the raw material from which judges, legislators and other legal actors fashion the various sources of law, including national constitutions, statutes, precedents and other legal phenomena such as contracts. As such, substantive reasons have primacy when law is made and thus are embedded in the positive law. Although the substantive side may be overwhelmingly predominant in a particular rule of positive law (especially rules incorporating standards of justice, fairness, and reasonableness), rules of positive law can never be drawn exclusively from substantive considerations. However, there may be no practical difference between a substantive rule of positive law and a pure reason of substance because judges are “empowered to incorporate substantive reasons into the law and then, in the same proceedings, may at once proceed to apply the formal legal norms thereby recognized and created.” Judges use substantive reasons when filling in gaps in statutes or, in matters governed by the common law, to decide cases of first impression or to choose between conflicting precedents. In this way, substantive reasons move from an existence outside the law to become part of the law. Substantive reasons also inform the law because they form the standards against which law is criticized and evaluated. For example, they form much of the basis for analysis of the implications of formalistic tax jurisprudence undertaken in chapter 4. The legal phenomena created from substantive reasons, such as constitutions, common law rules and doctrines, statutes, and contracts, serve as the basis for formal reasons.

5.1.1.2. Formal Reasons

When substantive reasons are incorporated into a rule they combine with formal attributes to produce the most common kind of formal reason, which is an “admixture of particular substantive reasoning and specific formal attributes.” Formal reasons, such as a

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344 Ibid.
345 Ibid.
346 Ibid.
347 Ibid at 6.
348 Ibid.
349 Ibid.
350 Ibid at 7.
particular rule of positive law, differ from substantive reasons because they serve as a basis for a judicial decision independent of the substantive reasons that were incorporated into that law, even when the substantive reasons do not apply to the circumstances at hand or point to a contrary conclusion from the substantive reasons underlying the rule. The classic example is a statutory provision that was enacted by the legislature on the basis of particular substantive reasons but which, especially in a formalistic approach to statutory interpretation, will point to a conclusion that is contrary to the substantive reasons which constituted the provision in the first place.

A point of clarification with respect to terminology is necessary at the outset. All of the reasons for decisions surveyed in chapter 3 are formal reasons in that they are all rules of positive law and therefore a legitimate basis for judicial decision. That is, both the substantive and formalistic jurisprudence of Canada, the UK, and the USA use formal reasons as their foundation. When the various formal reasons were formulated (the provisions of the ITA, the business purpose and economic substance doctrines, formalistic or substantive approaches to statutory interpretation) they were fashioned from substantive reasons. However, the formal reasons surveyed in chapter 3 are obviously situated on a continuum of highly formalistic formal reasons on the one hand and much more substantive formal reasons on the other. Highly substantive formal reasons are often referred to as principles or standards. Highly formalistic formal reasons are often referred to as rules. Therefore, the dichotomy of the two kinds of formal reasons is spoken of as the rules-standards dichotomy. The choice between the two is a choice between form and substance. In the analysis that follows, we are concerned principally with the latter dichotomy within the category of formal reasons and we will use the nomenclature of “rules” or “highly formal rules” on the one hand and “standards” or “substantive rules” on the other. Where it is necessary to refer to social, political, economic, and other values

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351 Ibid. at 7.
or ideas that exist outside of law, we will use the term “substantive reasons”. Indeed, the following analysis will touch on the manner in which substantive reasons enter Canadian tax jurisprudence to create standards in the form of collateral doctrines that cut down highly formal rules at the point of application in a process similar to the one that led to the creation of the American business purpose and economic substance doctrines. The latter is relevant because, as current Canadian tax jurisprudence obviously lacks a judicial form over substance doctrine, it is important to point out that the process of developing substantive standards in tax jurisprudence is a part of current adjudicative practice and therefore the process can be used legitimately by judges to create a judicial substance over form doctrine, as was done in the USA and UK.

5.1.2. Attributes of Formal Rules

When a rule of positive law is fashioned, a number of attributes of the rule determine whether it is a highly formal rule or a standard. These attributes include the content formality of the rule, the level of interpretive formality brought to bear on the rule, and the rule’s degree of mandatory formality.354 Each of these will be discussed below.

5.1.2.1. The Content Formality of Rules

Once substantive reasons are incorporated into rules of positive law, the rules that are created vary greatly in their content formality. That is, the content of a legal rule and therefore the content of the formal reasons it generates “may be shaped by an element of the arbitrary or by relevant reasons of substance, or both.”355 The degree of content formality of a rule is determined with reference to two attributes of rules: the extent to which the rule is shaped by fiat and the extent to which the rule is under or over inclusive.356 The latter attribute refers to the extent to which the rule will exclude cases that come with its object or purpose and includes

354 See Atiyah and Summers, supra note 271 at 12-17. The authors have identified a fourth attribute that they term “mandatory formality”, which may be described as the degree to which reasons are recognized as legally authoritative. Mandatory formality has been omitted from the discussion that follows, as it is assumed that the standards and highly formal rules discussed infra are recognized as legally authoritative and that this attribute of the rules and standards applied in tax jurisprudence is not seriously contested.
355 Ibid. at 14.
356 Ibid. at 13.
cases that would be excluded by its object or purpose. The rule that one must drive on the right side of the road has a high degree of content formality because the choice of which side of the road to drive on is entirely arbitrary and a matter of pure fiat.\(^{357}\) To the extent that rules are under or over inclusive, they generate formal reasons that are largely arbitrary and therefore have a high degree of content formality.\(^{358}\) For example, the formal requirement that a contract in respect of an interest in land must be in writing is over inclusive in that many agreements in respect of an interest in land will be invalidated. It is important to note that rules of both high and low content formality may exist within a particular field of law. For example, in traffic law, along with the highly formal rule regarding the side of the road upon which a motorist must drive (high content formality) is the rule prohibiting driving “without due care” (low content formality) or driving in excess of a specified speed limit (high content formality), or driving while drunk (low content formality), or driving with a blood alcohol level in excess of a specified figure (high content formality).\(^{359}\)

Chapter 3 demonstrated that between jurisdictions and at different times within a single jurisdiction, the degree of content formality in tax jurisprudence has varied. The US has business purpose and economic substance doctrines which are relatively substantive in nature and therefore have a low degree of content formality when compared to the highly formalistic Duke of Westminster principle that has dominated Anglo-Canadian tax jurisprudence. Canadian and UK tax jurisprudence have both alternated between high and low content formality with the current period characterized by high content formality. However, even in the current formalistic period of Canadian tax jurisprudence rules with low content formality exist. For example, the test for whether a worker is an employee or an independent contractor asks the simple but highly substantive question “was the worker in business on his own account?”\(^{360}\) Another recent example is the test for whether a business source of income exists which seeks to determine whether an activity with some personal element was conducted with sufficient indicia of business-like behavior.\(^{361}\) While tax law is an area that is dominated by statute, these substantive standards are proof of the ongoing need for and vitality of judge-made rules fashioned in case

\(^{357}\) Ibid.  
\(^{358}\) Ibid.  
\(^{359}\) Ibid.  
law in the manner of the common law. The need for common law standards in tax law arises from the inherent differences in the content formality between common law and statutory rules, a difference which makes each form of law amenable for use in solving different kinds of legal problems.

Common law and statutory rules have low and high content formality, respectively. For example, the basic rules of tort law are largely substantive in content. For example, in tort law the rule that requires persons to avoid causing injury by taking reasonable care engages substantive considerations like the particular merits and circumstances of the individual case and is therefore a rule of minimal content formality.362 Moreover, common law rules are rarely expressed in a fixed and unchanging textual form, a characteristic that allows them to be flexible and susceptible of application in wide-ranging factual circumstances thereby limiting their under and over inclusiveness.363 By contrast, statutory rules are in fixed verbal form and therefore tend to be more over-inclusive and under-inclusive.364 In addition, statutory rules are more often characterized by highly arbitrary content such as time limits, deadlines, stipulations as to place and amount, prescribed forms and the like, especially in statutes dealing with taxation and social security.365 One reason for this is that arbitrary lines reflect matters of expediency or policy rather than principle and therefore it seems more acceptable that such lines be drawn by legislators rather than courts.366 This is why we have “statutes of limitation and not precedents of limitation”.367 Far from establishing clear lines, case law is intrinsically a body of reasoned precedent, which means that it must necessarily be comprised largely of substantive principle rather than formalistic fiat.368 Moreover, case law can be more readily modified at the point of application so as to minimize the gap between the rules themselves and their substantive rationales and purposes, which is a feature incompatible with highly formal rules typical of statutes.369 Therefore, problems that will present themselves in highly varied forms from case to

362 Atiyah and Summers, supra note 271 at 14.
363 Ibid.
364 Ibid.
365 Ibid.
366 Ibid at 96.
367 Ibid.
368 Ibid. at 97.
case require the flexibility and adaptability of common law standards of relatively low content formality whereas problems that will be largely identical and amenable to resolution by the mechanical application of arbitrary rules that reflect policy decisions require statutory rules of high content formality. The inherent difference between the nature of case law and statute law with respect to content formality has lead some commentators to argue that anti-abuse standards in tax law should be judge-made rather than statutory due to the fact that the inherent rigidity of the latter would compromise the standard’s effectiveness. For example the inherently flexible judicial rule “cannot be undermined by microscopic examination in the search for loopholes.  

In tax law, the ITA abounds with highly technical and arbitrary rules with respect to penalties, tax rates, and filing deadlines. The latter attributes of statutes in general and the ITA in particular have contributed substantially to the recent revival of formalistic statutory interpretation at the Supreme Court of Canada that has cited the specific and detailed nature of the provisions of the ITA as a justification for avoiding a purposive approach. However, the common law, usually in the form of highly substantive standards set out in case law precedents figures importantly in determining the rules that govern matters not defined by the statute. For example, although the statute makes a distinction between transactions that are on account of capital and those that are on account of income, it offers no guidance as to how to make that distinction. That task lies with judges who, in a common law manner, have developed highly substantive rules and doctrines to answer the question. By necessity those doctrines must be flexible enough to account for the infinite variety of transactions that occur in the world in a way that is not possible for the highly formal rules in the ITA which are verbally fixed, unchanging, and relatively inflexible. The income versus capital issue demonstrates the way in which substantive judge-made doctrines and formal statutory rules can work together to create a functional legal regime in tax law, at least with respect to certain discrete questions. Given the inflexible, highly formal nature of statutes, it is perhaps not surprising that Canadian judges are unable to let themselves adopt substance over form approaches when applying various statutory rules. However, precisely because of the inflexible, highly formal nature of statutes, there is a

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370 See discussion at section 3, infra.
372 See e.g. 65302 British Columbia Ltd., supra note 191 at paragraph 51.
373 See Happy Valley Farms Ltd. v. The Queen, 86 DTC. 6421 (F.C.A.).
great systemic need for a substantive judicial substance over form doctrine to make the statute more functional by effectively addressing abusive tax avoidance. After all, abusive tax avoidance renders the statute inefficient by lowering tax receipts and imposing "an externality on everyone else in the form of higher tax rates."\(^\text{374}\)

5.1.2.2. **Formality in Interpretive Methods**

Both case law and statute law are subject to interpretation prior to judicial application and that interpretation may be more or less formal. An interpretation that focuses on the literal meanings of the words or on the narrow confines of a person's conduct is a highly formal approach to interpretation.\(^\text{375}\) Interpretation may be less formal and more substantive to the extent that the interpreter inquires into and gives effect to the underlying purpose of the statutory text that can be ascertained either from its face\(^\text{376}\) or from other sources such as legislative history.\(^\text{377}\)

A judge must make a decision on a question of interpretation even when an underlying purpose cannot be identified. In that situation, a judge must engage in yet another kind of substantive reasoning and rely on substantive reasons drawn from non-legal sources such as his own background political morality\(^\text{378}\), or on a political morality that he attributes to the legislature or to the public.\(^\text{379}\) Another such substantive approach, but one that is slightly more formal than the latter because it is less discretionary, is one that draws upon the body of the community's past judicial decisions as a whole, both within and beyond the specific area of law engaged by the statute to glean principles that can be applied to the novel problem at hand.\(^\text{380}\)

\(^{374}\) David Weisbach, "Formalism in the Tax Law," (1999) 66 U. Chi. L. Rev. 860 at 886 [Weisbach, "Formalism In the Tax Law"].

\(^{375}\) Atiyah and Summers, *supra* note 271 at 14.

\(^{376}\) Llewellyn, *The Common Law Tradition: Deciding Appeals* (Little Brown: Boston, 1960), 335 ("The best [rules] are relatively clear as to whether and when they apply; the best of them are shrewdly tailored to significant types of problem-situation; the best of them carry, also, their reason on their face.").

\(^{377}\) Atiyah and Summers, *supra* note 271 at 14.


\(^{379}\) Atiyah and Summers, *supra* note 271 at 15.

\(^{380}\) Dworkin, *Law's Empire, supra* note 4 (however, it is Dworkin's position that this approach is not discretionary at all).
Finally, different forms of law are not susceptible to the same degree of interpretive formality. Statutes, which are enacted in canonical and fixed verbal form, are susceptible to a relatively high degree of interpretive formality. However, the same cannot be said of case law which establishes rules in an \textit{ad hoc} manner in the context of unique fact situations that are not in fixed verbal form. To the contrary, standards and doctrines formulated in case law often exhibit variation in verbal expression from one factual context to another on a case by case basis. Even often cited passages of seminal cases are generally not subjected to the kind of dissected, technical analysis of individual words, and the placement of punctuation completed with the assistance of competing dictionary definitions and treatises on grammar as are statutes.

The difference in interpretive methods as between case law and statutory law is due to the differences in the nature and function of those two forms of law within a legal system. Case law and the doctrines and rules it develops are suited to the regulation of the infinite and dynamic variety of life. Case law generally is concerned with the past, with cleaning up the "messes" that result after individuals or corporations have undertaken a course of conduct in unique factual circumstances that raise legal issues.\footnote{Atiyah and Summers, \textit{supra} note 271, at 98.} Statutes, on the other hand, are largely concerned with the future, with prescribing legal consequences for events yet to happen.\footnote{Ibid.} Therefore, statute law is more suited to relatively static endeavors such as the establishment of regulatory frameworks, procedures, institutions, and the like, and case law is suited to the resolution of legal problems arising from novel and unpredictable life situations.

With the latter considerations in mind, it is proper that the ITA receive a\textit{ largely} formalistic interpretation. This much has been accepted the Supreme Court of Canada. For example in \textit{Canada Trustco}, it made the case for an "emphasis" on textual interpretation:

\begin{quote}
However, the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation. Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.\footnote{Canada Trustco, \textit{supra} note 153 at paragraph 11.}
\end{quote}

\footnotesize
\begin{itemize}
\item \footnote{Atiyah and Summers, \textit{supra} note 271, at 98.}
\item \footnote{Ibid.}
\item \footnote{Canada Trustco, \textit{supra} note 153 at paragraph 11.}
\end{itemize}
This conclusion is sound as far as it goes but the Supreme Court gives no indication about when a more substantive approach is justified and seems unable itself to draw that line. Given the nature and limitations of statutory rules, formalism is justified only when the case is concerned with the common and usual business transactions of the everyday world against which the provisions of the ITA were written.  Consequently, formalism will govern most instances of the application of the ITA. Indeed, the administration of the ITA would be seriously impaired if substantive rules were applied to common business transactions. However, the conclusion is otherwise when what is at issue is not a common business transaction but an unusual, complex, tax motivated avoidance transaction with no business purpose that results in unintended tax benefits. Such a transaction does not fit within the category of static endeavors that justify a formalistic approach. Rather it is a transaction that, due to its novelty, demands a substantive approach that can account for the infinite and dynamic variety of tax avoidance behaviour. In keeping with the respective functional natures of statute law and case law, such substantive approaches must be developed in case law in relation to the facts of the case at hand. Legislative attempts are likely to be excessively rigid and therefore ineffective for the very reason that they are statutory and therefore likely to be formalistically interpreted. The Canadian statutory GAAR has fallen victim to precisely this fate.

5.1.2.3. Mandatory Formality

Formal reasons (rules of positive law) generally have a high degree of mandatory formality in that it is part of their intrinsic nature that they override, exclude from consideration, or diminish the weight of other substantive reasons that could otherwise inform the resolution of a particular legal problem. However, there are two kinds of mandatory formality. On the one hand, rules and other legal phenomena that form the basis for judicial reasons have a prima facie mandatory formality. On the other hand they have an “ultimate degree of mandatory formality

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384 See Surrey, “Complexity”, supra note 291 at 707 (“It is clear that [various anti-avoidance provisions in the law at that time] save the tax system from the far greater proliferation of detail that would be necessary if the tax avoider could succeed merely by bringing his scheme within the literal language of substantive provisions written to govern the everyday world.”)
385 See David Weisbach, “Formalism in the Tax Law,” supra note 374 at 866-867
386 Ibid. at 867-872.
387 See chapter 4, supra.
388 Atiyah and Summers, supra note 271 at 16.
that remains after defenses and collateral doctrines have been taken into account” at the point of
application of a particular rule. Like the other varieties of formality, legal phenomena have
varying degrees of mandatory formality. “For instance, a rule prohibiting the playing of musical
instruments in the park on unqualified terms is at least prima facie of high mandatory formality;
on the other hand, a rule prohibiting the playing of unreasonably noisy musical instruments is
clearly of lower prima facie mandatory formality.”

Mandatory formality can be profoundly affected by what happens at the point of
application or enforcement of rules, typically in the context of adjudication. Rules of any degree
of prima facie mandatory formality can be cut down at the point of application by the extent to
which countervailing considerations are accorded legal effect. Such countervailing
considerations often take the form of defenses or collateral doctrines that are explicitly made part
of the law. The American business purpose test is an obvious example of such a collateral
doctrine. Before Justice Hand heard Gregory, it seemed that the rules of the tax code provided
for a mandatory tax free treatment of the reorganization undertaken by Mrs. Gregory. In his
reasons, Justice Hand cut down the prima facie mandatory formality of the reorganization rules
by applying the collateral doctrine of the business purpose test. Although the business purpose
test was conceived of in Gregory as an incidence of statutory interpretation, it has since
developed into a collateral doctrine. For example, Joseph Bankman writes that:

The economic substance doctrine, like the other common law tax doctrines, can ... perhaps best be
thought of as a method of statutory interpretation. ... It is in one sense odd to think of the
economic substance doctrine as an interpretive method. This is because the doctrine is only
loosely connected to more conventional interpretive techniques or approaches. Decisions in which
the doctrine is discussed or invoked often contain a separate discussion in which text, intent, and
purpose are applied to the issue at hand. The doctrine itself, however, is discussed and applied
without significant discussion of text, intent, and purpose.

Therefore, in the manner of its application, the economic substance doctrine is not merely an
incidence of statutory interpretation but is applied like a collateral doctrine. Joseph Isenbergh is
more explicit, referring to the business purpose and related doctrines as “extrastatutory
standards” that constitute “the existence alongside the Internal Revenue Code of an additional

389 Ibid.
390 Ibid.
391 Gregory, supra note 78.
(and somewhat autonomous) set of principles for deciding tax disputes.\textsuperscript{393} The equivalent UK doctrine has received the same assessment from Lord Hoffman, writing in criticism of the decision of the House of Lords in Barclays Mercantile\textsuperscript{394} that seems to have discarded the doctrine. Lord Hoffman argues that the Ramsay\textsuperscript{395} and Furniss\textsuperscript{396} doctrine in UK jurisprudence has been taken to mean that, whatever may be the terms of the statute, a transaction which has no business purpose cannot have any effect on liability for tax, stating that “[t]his ‘business purpose’ rule … does not purport to be anchored in the meaning of the statute … It purports to be an all-purpose anti-avoidance remedy which dissolves the tax effects of avoidance schemes”.

Therefore, the USA and UK (admittedly the latter has regrettably abandoned the collateral doctrine recently) have adopted collateral doctrines that undercut the formality of statutory rules in order to account for uncommon, abusive transactions that fall outside of the scope of those rules. Judges in those countries have understood the respective roles played by highly formal statutory rules and substantive anti-abuse standards developed in case law and that a combination of the two in tax jurisprudence produces a more functional, efficient, fair, and just system of taxation.

The creation and application of such collateral doctrines is not a peculiarly American or UK phenomenon. Despite its reluctance, since the late 1990s, to apply an economic substance doctrine in tax avoidance cases, Canadian tax jurisprudence has created and applied substantive collateral doctrines in other tax contexts. A striking example from Canadian tax jurisprudence of a \textit{prima facie} mandatory rule that is subject to a collateral doctrine at the point of application is the automatic penalty imposed by section 280 of the \textit{Excise Tax Act}\textsuperscript{398} for failing to remit the correct amount of tax. The example is striking because it involves a statutory rule of extremely high mandatory formality, the statutory language of which leaves little room to read in a defence of any kind:

\textsuperscript{393} Isenbergh, “Musings”, \textit{supra} note 70 at 863-864.
\textsuperscript{394} See note 118, \textit{supra}.
\textsuperscript{395} See note 107, \textit{supra}.
\textsuperscript{396} See note 108, \textit{supra}.
Subject to this section and section 281, where a person fails to remit or pay an amount to the Receiver General when required under this Part, the person shall pay on the amount not remitted or paid

(a) a penalty of 6% per year, and

(b) interest at the prescribed rate,

computed for the period beginning on the first day following the day on or before which the amount was required to be remitted or paid and ending on the day the amount is remitted or paid.

The statute did not explicitly provide for any defence to the penalty, as it did in other circumstances such as the statutory due diligence defence against a director's liability for the tax debts of her corporation. Nevertheless, in Canada (Attorney General) v. Consolidated Canadian Contractors Inc., the Federal Court of Appeal affirmed a decision of the Tax Court of Canada that held that the seemingly mandatory and automatic penalty imposed by the Excise Tax Act was subject to a highly substantive defence of due diligence. The decision is a perfect case study of law as integrity operating in tax law, of how and when a court will import substantive reasons into the law to create a substantive standard in the form of a collateral doctrine by referencing norms and values that are embodied in the greater body of law. It provides a lucid example of how substantive reasons like fairness enter the law to undercut the mandatory formality of statutory rules.

In Consolidated Canadian Contractors the Federal Court of Appeal relied on the decision of the Supreme Court of Canada in Sault Ste. Marie where the latter court was asked to consider whether Canadian law should recognize strict liability offences. Sault Ste. Marie injected a significant amount of substance into a wide cross-section of Canadian law that previously exhibited a high degree of mandatory formality, including tax law as illustrated by Consolidated Canadian Contractors. Sault Ste. Marie recognized, for the first time in Canadian law, three categories of offences. The first consists of offences that are criminal "in the true sense" and in which mens rea must be proved by the prosecution. The second is strict liability offences, such as public welfare or regulatory offences, for which there is no need to prove mens rea, but where it is open to an accused to prove that she exercised reasonable care. The third

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399 Ibid, section 323.
category consists of absolute liability offences in which it is not open to an accused to establish that she was “free of fault”.

The Supreme Court’s reasons in *Sault Ste. Marie* were informed by the substantive and moral reason that there should be no punishment without fault. That particular substantive reason has also long been a fundamental tenet of the common law. As such, the decision was informed by principles and values that were expressed in the law generally and the result made the law of regulatory offences integral with the greater body of law. Justice Dickson outlined the analytical framework for identifying absolute liability offences:

> Offences of absolute liability would be those in respect of which the Legislature had made it clear that guilt would follow proof merely of the proscribed act. The overall regulatory pattern adopted by the Legislature, the subject matter of the legislation, the importance of the penalty, and the precision of the language used will be primary considerations in determining whether the offence falls into the third category.  

Therefore, a host of substantive factors will be applied to determine whether a substantive collateral doctrine is available to offset the application of a seemingly mandatory rule of high content formality that a penalty shall be imposed for the commission of a specified act.

The precedential significance of *Sault Ste. Marie* lies in the fact that it recognizes strict liability offences for which the defence of due diligence is available, without restricting the availability of that defence to the specific category of public welfare or regulatory offence that was involved in that case. Therefore, in the view of the Federal Court of Appeal, it was open to it to determine whether the defence of due diligence may, as a matter of principle, be raised in the context of the administrative penalties contained in section 280 of the *Excise Tax Act*. In coming to the conclusion that the penalty in section 280 was subject to a substantive defence, the Federal Court of Appeal referred heavily to the norms and values expressed in the legal record as a whole as a justification for “reading in” the substantive collateral doctrine of a due diligence defence.

At the centre of the controversy in *Consolidated Canadian Contractors* was Justice Bowman’s influential decision in *Pillar Oilfield Projects Ltd. v. The Queen*  

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402 Ibid. at 1326.
403 (1993), 2 GTC 1005 (T.C.C.).
subject to reversal if the Federal Court of Appeal allowed the Crown's appeal), which held that it would be contrary to the principles of "fundamental justice" and "fairness" to withhold the right to plead due diligence with regard to penalties imposed under section 280. Justice Bowman expressed frustration at the lack of a due diligence defence in the following manner:

That a person should be susceptible of being penalized administratively by a public servant without any possibility of exculpating himself by demonstrating due diligence is not only extraordinary. It is abhorrent. It is no less abhorrent because it is mechanically and routinely imposed by anonymous revenue officials and therefore qualifies for the essentially meaningless rubric "administrative" rather than "criminal". A punishment is a punishment. Neither its nature nor its effect is tempered by the use of palliative modifiers.404

The reasoning of the Court of Appeal in Consolidated Canadian Contractors is worth quoting at length because it is a case study that vividly illustrates much of what has been discussed in the abstract above about the nature of formal and substantive reasons and the interaction between the two, as well as the operation in practice of law as integrity. The court's reasons for judgment also highlight the degree to which substantive reasons inform judicial decisions and the manner in which substantive considerations interact with the formal aspects of the law. There tends to be an underlying assumption in Canadian tax jurisprudence that it is unthinkable to create a collateral doctrine such as a business purpose test that could undercut the formality of the provisions of the ITA at the point of application. However, that is precisely what the Federal Court of Appeal did in Consolidated Canadian Contractors. In that regard, the decision serves as a reminder of the ability of judges to account for substantive circumstances when applying otherwise formal rules. The court states:

Recognition of the fact that the due diligence defence may be available in cases involving administrative penalties leads to a further question: Is it permissible to read in the due diligence defence solely on the ground that its absence conflicts with our understanding of "fundamental justice" or "fairness"? While the issue appears not to have been raised in Pillar Oilfields, it appears that Judge Bowman assumed as much. The question is of paramount importance because it brings into issue the limits of judicial discretion in the interpretation of statutes and the policy-making role of courts. It is as relevant today as it was when the literal and golden rules of construction constituted the accepted model of interpretation. Allow me to explain.405

At the outset, the court is conscious that the question raises the issue of importing substantive reasons into the law to create a collateral doctrine that would compromise the prima facie

404 Ibid. at 1009.
405 Consolidated Canadian Contractors, supra note 400 at paragraph 25 [emphasis added].
mandatory formality of the statutory rule. While the court refers to “policy-making”, this does not seem to be an appropriate description for what the court is doing. Policy-making is, of course, more appropriately a legislative enterprise but, as will become evident below, the Federal Court of Appeal is really engaging in a constructive interpretation of the law in applying principle to the case at hand (the court looks values embodied in common law principles and not to extralegal considerations that are typical in the formulation of policy). That is an inherently judicial function and need not be the cause of any judicial anxiety.

Initially, the court tries to use the principles of statutory interpretation to read in a defence in a strategy similar to that of Justice Hand in Gregory.\(^{406}\)

The “literal” or “plain meaning” rule of construction directs that if the words of the text are ambiguous on their face, then it is permissible to go beyond that immediate context to ascertain their meaning. However, “[i]f the precise words used are plain and unambiguous, ... we are bound to construe them in their ordinary sense, even though it do lead ... to an absurdity or manifest injustice” (Abley v. Dale (1851), 138 E.R. 519 (C.P.), at page 525).

An interpretation which leads to an absurd result or manifest injustice undermines public confidence and respect in the judicial system. Thus, it is not difficult to understand why the literal rule of construction would, with the passage of time, be qualified by the “golden rule” which directs that the grammatical and ordinary sense of words need not be adhered to if their meaning leads to a “repugnance” or “inconsistency” with the rest of the instrument, or to an “absurdity”: see Grey v. Pearson (1857), 10 E.R. 1216 (H.L.), at page 1234. In short, a contextual approach has to be taken to determine whether the “plain meaning” leads to a repugnancy or inconsistency with the legislation. However, since the term “absurdity” is itself ambiguous, its use has always been a source of controversy.\(^{407}\)

However, the court explicitly acknowledges that the principles of statutory interpretation are often a way to inject judicial values into statutory rules and so proceeds with caution:

Applying the golden rule of interpretation to the facts of this case, the issue is whether the lack of a due diligence defence qualifies as an “absurdity”. In other words, is the manifest unfairness which results from imposing a penalty on a registrant, despite having taken all reasonable measures to avoid it, a sufficient reason for importing a due diligence defence into the Excise Tax Act? During the height of the legal realist movement in Canada, Professor Willis observed that it was impossible to reconcile the case law as to what constitutes an absurdity: “It is infinitely more a matter of personal opinion and infinitely more susceptible to the influence of personal prejudice” ... In his estimation, the golden rule was simply a device employed by judges to achieve a desired result. A half-century later, Professor Sullivan asks whether the concept of absurdity extends to “consequences that are judged to be undesirable because they contradict values or principles that are considered important by the courts”. Her question has obvious relevance to the present case because of the reliance placed on the principle that there should be no punishment without fault...

In addressing Professor Sullivan’s question, one cannot escape the fact that the exercise of judicial discretion through the interpretation of statutes has traditionally been a source of unease. The underlying

406 Gregory, supra note 78.
407 Consolidated Canadian Contractors, supra note 400 at paragraph 27.
fear is that the line to be drawn between interpretation and policy making will disappear, and that statutory interpretation will dissolve into judge-made law. This contravenes our understanding of parliamentary sovereignty in which validly enacted legislation is considered paramount to judge-made law and courts are obliged to defer to the legislature’s public policy choices as expressed in the language of the statute.\footnote{Ibid. at paragraphs 28-29 [emphasis added].}

Now switching from caution to boldness, the court seems to view the injection of judicial values (which in its view are values that judges believe are shared by the general public) as legitimate and puts the onus on the legislature to be explicit if it intended to legislate in derogation of those values. The court reinforces this position by equating judicial values with those of the community as a whole, appealing to the authority of the community’s political morality in the manner of Dworkin’s law as integrity adjudication:

I also recognize that the interpretative process is infused with judicial values which are not to be equated with the personal views of individual judges, but rather with those that the judiciary believes are shared by the general public. The concepts of individual liberty and private property, for example, continue to "inform our fundamental political arrangements - our Constitution", and give rise to strong rebuttable presumptions in favour of individual rights.\footnote{Ibid, at paragraphs 30-31} I would like to stress that these presumptions underlying statutory interpretation are not simply tie-breaking rules to be applied whenever the conventional rules are found to be inadequate. Rather, they should remind draftspersons that the clearest possible language must be employed if they seek to achieve ends which are antagonistic to fundamental common law values or principles. Unless such language is crystal clear, courts are not going to go out of their way to draw inferences from legislation with respect to Parliamentary intent that would negate those values.

For example, the presumption against retroactive legislation is well established and uncontroversial.\footnote{Ibid at paragraph 29} The rationale underlying this presumption was best explained by Duff J. in Upper Canada College v. Smith\footnote{[1936] A.C. 1 (H.L.), at page 19} where he stated: “it would not only be widely inconvenient but a flagrant violation of natural justice to deprive people of rights acquired”. (One cannot help but note at the similarity of language used by Judge Bowman in Pillar Oilfield.) Professor Sullivan notes that this presumption is “heavily weighted” and “difficult to rebut”... I agree.\footnote{Ibid, at paragraphs 30-31}

It is significant that in the course of this struggle between substantive reasons and highly formal statutory rules, the court refers to the infamous Duke of Westminster decision as the prototype example of judicial values influencing the interpretive process. The court rightly predicts that without the principle laid down in that case, the law of tax avoidance would have taken a radically different course:

If there is any doubt as to the influence which judicial values have on the interpretative process, one need only turn to tax law. Lord Tomlin’s often-cited maxim in Inland Revenue Commissioners v. Westminster (Duke of), [1936] A.C. 1 (H.L.), at page 19, is as influential today as it was when it was written some sixty years ago. It essentially states that taxpayers are entitled to arrange their affairs so as to minimize their tax liability. Without that interpretative guideline, the law of tax avoidance would, in my view, have taken a
radically different course. In other legislative settings, it is generally accepted that one cannot achieve indirectly what cannot be done directly.410

The passage immediately above exposes the court’s lack of confidence about whether the Duke of Westminster principle really is integral with the larger body of law. The court suggests that but for the Duke of Westminster the law of tax avoidance would have been different. Presumably, the court means that it would have been substantive and more horizontally consistent with what the court sees as the norm in the greater body of law, namely the principle that you cannot do indirectly what you cannot do directly. The problem for the court, therefore, is not whether to decide the case at hand with reference to norms and values but to ensure that the correct norms and values are chosen. In the passage above, the court rightly displays a preference for those norms and values expressed in the greater body of law over the more suspect values held by individual judges that may not be strongly manifested in the law generally. The court then goes on to explicitly consider the judicial value at stake in the case, namely that there should be no punishment without fault, which is a substantive reason that has been expressed in the common law.

In the present case, the judicial value being challenged is the general right of persons not to be punished without fault, which is consistent with the common law principle that there should be no liability without fault. ...

This is the same value which motivated common law judges to require that mens rea be proven to support a criminal conviction. It also prompted the Supreme Court in Sault Ste. Marie to create a category of strict liability offences while continuing to preserve the common law notion of absolute liability. It comes as no surprise to me that courts are reluctant to accept a passive role in the application of penal provisions which impose a disproportionately heavy burden on persons where the legislative advantages are slight. It is the same attitude which compelled the courts of equity to provide relief from penalty and forfeiture clauses.

Returning to the question of whether patent unfairness is a sufficient reason to import a due diligence defence into section 280 of the Excise Tax Act, I must respond in the negative. The common law principle that there should be no punishment without fault is capable of supporting the concept of strict liability in cases involving administrative penalties. It is also capable of giving rise to a rebuttable presumption that Parliament did not intend to establish absolute liability in cases involving section 280 of the Excise Tax Act. 411

The court struggles to avoid recognizing the due diligence defence on the basis of a purely substantive reason such as “patent unfairness”. Instead, it relies on the “common law principle that there should be no punishment without fault”, which is really just an articulation of the idea

410 Ibid. at paragraph 32.
411 Ibid. at paragraphs 33-35.
of patent unfairness. It is the substantive goal of fairness which has been embedded in the law through judicial recognition.

It is important to note that the court emphasises that it is not acting arbitrarily. As discussed in section 1, arbitrariness is the hallmark of legislative rules. Therefore, judicial arbitrariness is contrary to the principle of parliamentary supremacy:

However, it is the Court’s responsibility to consider the legislative context surrounding that provision and its purpose. After all, Parliament may have decided to impose absolute liability on the understanding that its benefits outweighed any unfairness to registrants. To extend relief solely on grounds of unfairness would, in my view, disregard the approach taken in Sault Ste. Marie. It would also be tantamount to declaring that all administrative penalties are subject to a due diligence defence provided that judges can identify a perceived “injustice”. If the distinction drawn in Sault Ste. Marie between absolute and strict liability offences is to be applied to administrative penalties, then so too must its analytical framework. This is not to suggest that the task of distinguishing between strict and absolute liability provisions is problem-free. The benefit derived from the application of an analytical framework is that it deflects criticism based on judicial arbitrariness.\footnote{Ibid. at paragraph 35.}

The court reiterates the fact that it is applying Sault Ste. Marie and the “framework” set out in that case. That “framework” is a judge-made standard, highly substantive in nature, to determine whether an offence is subject to a due diligence defence, another substantive standard. This highlights the remark made at the outset of this discussion of the reasoning in Consolidated Canadian Contractors, that the court has mischaracterized its reasoning as “policy-making”. To the contrary, the court’s reasoning is confined and constrained by the standards developed by the Supreme Court of Canada and by the principles of the common law. As such, the court is well within the confines of the usual judicial role of principled adjudicator. Moreover, while the court believed that the case before it raised questions about the limits of judicial discretion, there was little, if any, discretion available to the court. After all, the court was not working with pure substantive reasons. It was working with rules of positive law, namely the standards and the values that are embodied in the common law. The point to recognize is that judges use substantive reasons in the form of values or political morality expressed in the law as a whole to create and give force to collateral judicial doctrines that, as is the case in Consolidated Canadian Contractors as well as in Gregory\footnote{Gregory, supra note 78.}, take the form of highly substantive standards that serve to undercut otherwise mandatory statutory rules in the context of adjudication. Moreover, when they do so, they are not usurping the policy making role of the legislature. Far from engaging in
policy making, they are finding principles in the norms, values and political morality of the community as expressed in the legal record through a process of constructive interpretation that makes the legal record the best that it can be. Those principles are anchored in the past and yet serve as a foundation for future decisions. Such a process is not legislative at all, it is the very hallmark of legal adjudication.

5.2. THE CHOICE BETWEEN RULES AND STANDARDS

Tax law, like the rest of the legal system, is a system of rules. Section 5.1 sketched out the anatomy and genesis of the dichotomy of highly formal rules and relatively less formal and therefore more substantive standards. Like the rest of the legal system, tax law is composed of both kinds of rules and the choice between the two is really a choice between form and substance. This section takes account of the functional justifications for formal and substantive reasoning in law to delineate their respective domains within a legal system by identifying the kinds of legal solutions that are promoted by each of the two varieties of rules. This section will look at the general justifications for each type of rule to create a framework that will be applied in section 5.3 to the particular case of tax law. The following analysis reveals that in cases involving tax avoidance, the cases where the form and substance problem is most often is most often engaged in tax law, the general justifications in favour of formalistic reasoning and the use of highly formal rules often break down suggesting that substantive approaches are much more appropriate.

5.2.1. Justifications for Formal Reasoning

There are many justifications for resort to formal reasoning in the law but the most important and fundamental reasons are pragmatic and functional. In addition to this primary justification, others are that highly formal rules are generally less costly and more efficient, highly formal rules are thought to minimize the risk of judicial error, promote certainty,

predictability, and deterrence. Furthermore, resort to highly formal rules is often justified with reference to what are perceived to be the deficiencies of standards, namely that standards have a "chilling" effect in that they deter both desirable and undesirable conduct. This section makes a positive case for the use of formalism in law generally, as it has undeniable utility in many areas of the law. The case for standards in tax jurisprudence is made in response to the attributes of formalism that make it useful in the law generally, but that have not translated well into tax jurisprudence, especially the jurisprudence of tax avoidance, which requires a substantive approach.

5.2.1.1. Pragmatic and Functional Justifications for formal reasons

The most important justification for the resort to formal reasons is pragmatic and functional. A fundamental function of the legal system is the need to reach legally binding decisions. This requires proper procedures for the orderly making of decisions that have some finality:

But to do things in an orderly manner requires that proper procedures should exist for regulating how disputes should be determined and how public affairs should be organized. Efficient procedures for such matters require that there should be a proper time and place in which issues can be raised, appropriate procedures for raising issues, and proper officials before whom they can be raised. That means that when a matter is brought before an official for a decision to be made - whether the issue is a litigated case before a judge or a bill brought before a legislative assembly - there must exist rules whereby certain matters can be raised, and certain matters cannot be raised. Matters which are out of order cannot be raised now, before this assembly or judge, on this occasion, by this procedure. This makes it highly desirable (to say the least) that rules should be treated as giving rise to formal reasons for decisions. Treating rules in this way prevents countervailing substantive reasons being brought up whenever a rule is involved, and thus provides a powerful reason for ruling matters out of order in a discussion.415

Therefore, the pragmatic and functional justification has to do with the pragmatic reality that for the legal system to function in an orderly manner, there must be established procedures and rules for what kinds of substantive reasons can be raised, when, and before which legal body. For example, for pragmatic and functional reasons a legislative decision to tax only 50% of capital gains but 100% of net business income cannot be revisited in Tax Court with an appellant arguing, perhaps with reference to all sorts of economic and sociological data, that only 50% of his business income should be taxed. If the legal system did not rely upon formal reasons that prevented courts dealing with such issues, judicial adjudication would impossible as one party

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415 Atiyah and Summers, supra note 271 at 24-25.
would be permitted to argue that an applicable legal rule should not be followed in the case before the court because countervailing substantive considerations were not properly accounted for or not considered at all when the rule was originally formulated. Formal reasons prevent such a situation by limiting and controlling what is relevant in the context of the adjudication of a dispute. “Formal reasons enable us to say: this issue is to be debated within certain limits, other matters are not on the agenda today; or, this case is to be decided as a dispute between these parties on certain assumptions which are not open for discussion here and now.” The latter attribute of formal reasons is more pronounced for highly formal rules than it is for comparatively substantive standards. For example, in tax law a formalistic approach to statutory provisions forecloses all considerations of substance at the level of adjudication, requiring that all such considerations be raised before the legislative branch and embodied in the text of the provision well before adjudication and even before the taxpayer acts. This means that all avoidance transactions must have been anticipated in advance by the legislature because reasons of substance bearing upon unanticipated transactions cannot be raised before a court. However, substantive standards such as the business purpose and economic substance doctrines allow the court to take account of reasons of substance such as taxpayer purpose, the economics of the transactions such as possibility of profit, amount at risk, comparison with similar transactions undertaken by other business, and the like, all of which are off-limits if a highly formal statutory rule is involved (unless the statutory text explicitly mentions any of these) and the court recognizes no applicable collateral doctrine. Note that substantive standards are still in the category of formal reasons and therefore they only allow for the consideration of reasons of substance that are within the scope of the particular standard. They do not invite judges to consider any substantive reason under the sun. Such a standard would not be a rule of law at all and would not be tenable in a system that is founded upon the rule of law.

The widespread use of highly formal rules and formalistic reasoning presupposes that relevant substantive reasons could have been or have already been considered more appropriately and effectively by some other official or institution. This is because a decision made with reference to highly formal rules refuses to consider reasons of substance that bear on the issue arising in the circumstances of the case. For a judge to exclude such considerations, he must be

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416 Atiyah and Summers, supra note 271 at 25
417 Ibid. at 36.
confident that the rest of the legal system is working properly, so that he can exercise legitimately and justifiably refuse to deal with it himself, here and now.\(^{418}\) Thus, in the case of formalistic statutory interpretation it may be legitimate to ignore the result and any legislative intention that is not evident in a textualist reading if a judge can assume that the legislature has drafted and enacted its statutes with care. Such an assumption gives rise to a strong presumption that the literal meaning of the words of a statute expresses the intention of the legislature.\(^{419}\) In tax cases, such a presumption gives rise to the familiar judicial refrain that if parliament intended the ITA to have the effect advocated by counsel, then the statute would have been drafted differently. Formalistic interpretation is further justified if the legal officials responsible for applying or enforcing the law will “nevertheless take account of some of the substantive reasons which appear to have been overlooked by the legislature and apply the statute in a sensible manner; and thirdly ... the legislature is likely to act reasonably promptly to remedy any deficiencies in the law caused by such a decision.”\(^{420}\) Generally speaking, resort to formalistic reasoning can be justified on these assumptions and if they cannot be made with confidence, then formalistic reasoning has less place in a legal system.\(^{421}\) For instance, it is obviously not justifiable to employ formalistic statutory interpretation in a situation where statutes are badly drafted or ill considered, where legal officials routinely arrive at an absurd result when applying statutes and where the legislature cannot be relied upon to quickly correct any such absurdities.\(^{422}\) The conclusion is the same if there are other reasons why reasons of substance were not or could not have been considered by the legislature or some other competent body.

In tax law, the phenomenon of tax avoidance gives rise to such a consideration that greatly weakens the justification for a formalistic approach in tax avoidance cases. Tax avoidance is only possible when taxpayers, before they design and document their transactions, know and account for the fixed statutory provisions that they must navigate with the transactions they design in response to the provisions. It is not possible to draft a taxation statute that anticipates and takes account of the taxpayer reaction to the provisions enacted; this is tax law’s blind spot, which tax avoidance exploits. Any attempt at anticipation would result in an

\(^{418}\) Ibid. at 37.
\(^{419}\) Ibid. at 36.
\(^{420}\) Ibid. at 37.
\(^{421}\) Ibid. at 40.
\(^{422}\) Ibid. at 37.
unending drafting process where rules are formulated, possible avoidance transactions anticipated and more rules are formulated to prevent those transactions and then more avoidance transactions are anticipated to navigate around the new set of rules and so on and on. Such a process could continue perpetually with the complexity of the statute reaching unimaginable levels. Indeed, the current density and complexity of the ITA is the result of a similar process played out not in a legislative drafting room but in the courtroom over decades of legislative action and taxpayer reaction, during which time formalistic statutory interpretation has been the dominant approach in Canadian courts. Because the problem of tax avoidance is evidently not one that the legislature is institutionally equipped to deal with, formalistic reasoning and the banishment of substantive standards in tax avoidance cases has little justification. In other words, it was not possible that the relevant substantive considerations with respect to an unanticipated avoidance transaction were taken into account by some other body at some other time. The only place to realistically take such considerations into account is before a court and the function of formulating standards to account for such considerations at the point of application of the ITA is a judicial function, as it is intrinsically suited to flexible case law rather than rigid statute. The American judiciary appears to have understood this and as a result, the American legal system “declines to make assumptions about the proper working of the rest of the political and legal machine which are foundations for the more extensive use of formal reasons” and consequently relies more heavily in tax cases on substantive standards such as the business purpose and economic substance doctrines.

Section 5.3, below, elaborates on the pragmatic and functional reasons to prefer standards over highly formal rules in tax avoidance cases in making an affirmative case for the use of standards in tax jurisprudence.

5.2.1.2. Cost and efficiency

Other reasons for resort to formalistic reasoning and highly formal rules include cost and efficiency: formal reasons are cheaper. For example, a substantive approach to statutory interpretation is more expensive than a formalistic approach that restricts interpretation to the

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423 Ibid.
424 Ibid. at 25-26.
statutory text. By comparison, a substantive approach raises questions of purpose and legislative intent that require a relatively greater commitment of resources on the part of the parties to the litigation and the court that hears it. When law is meant to apply to common, everyday transactions, highly formal rules are justified for cost and efficiency reasons. However, where the transactions are uncommon, the cost and efficiency argument breaks down because the cost of substantive standards is low when they are engaged at a low frequency.\textsuperscript{425} For this reason, the cost and efficiency justification for formalistic reasons breaks down in the context of tax avoidance cases. A formalistic approach to the ITA is appropriate when dealing with the common business transactions with reference to which most of the statutory provisions were drafted because the cost of applying standards to the extreme multitude of such transactions would be grossly expensive and inefficient. However, the opposite is true in tax avoidance cases where the avoidance transactions involved are, by definition, not regular, everyday business transactions. Many of them are extremely novel and relatively rare transactions with no business purpose at all.

### 5.2.1.3. Minimizing the risk of judicial error

Highly formal rules are thought to minimize the risk of judicial error.\textsuperscript{426} For example, a requirement that a will be in writing reduces the risk that, in the case where there is no written will, a judicial inquiry into the intentions of the testator will yield a result that is, in fact, inconsistent with the testator's actual but unexpressed intentions. The same dynamic may be at work in tax cases that call upon judges to interpret the ITA, an exceedingly complex and difficult statute that embodies obscure economic and financial policies, incentives, and political compromises in fiscal and economic matters. Judges are reluctant to stray from the anchor of the plain meaning of the words of the statute for fear that they may venture into what they may view as the judicially inaccessible realm of fiscal policy. The Supreme Court of Canada expressed this kind of trepidation in \textit{Canada Trustco}:

\textsuperscript{425} See discussion at section 5.3.4, infra.
\textsuperscript{426} Atiyah and Summers, supra note 271 at 36 at 26. See also, \textit{Friedrich A. Hayek, The Road To Serfdom} (Chicago: University of Chicago Press, 1944) 72-73; Duncan Kennedy, "Form and Substance", \textit{supra} note 313 at 1688; Frederick Schauer, \textit{Playing By The Rules: A Philosophical Examination Of Rule-Based Decision-making In Law And In Life} (Oxford, England : Clarendon Press, 1991) at 149-55 (arguing that the use of rules minimize decision-maker error and reduce abuse that results from bias, ignorance, incompetence or confusion).
To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of tax policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped.\(^{427}\)

The Supreme Court of Canada displays excessive caution in this passage. The court need not stray into the formulation of tax policy. The court merely needs to conceive of its role as including the prevention of tax avoidance. Such a role is obviously consistent with the intention of a parliament that enacted a GAAR.

### 5.2.1.4. Certainty and Predictability

Certainty and the restraint of official arbitrariness are virtues of highly formal rules. Official arbitrariness refers to the many reasons for decisions that are inappropriate, ranging from corruption to political bias and the use of such reasons for a decision is seen as an evil in itself.\(^{428}\) Certainty is valued for its effect on citizens in that it enables them to know in advance the instances of state intervention enabling them to account for such intervention in planning their activities thereby lending predictability to private activity.\(^{429}\) Certainty also removes from private activity the disincentive for action that arises when "one's gains are subject to sporadic legal catastrophe."\(^{430}\) However, due to the frequency with which the Supreme Court of Canada invokes the value of certainty in finding for the taxpayer in tax avoidance cases,\(^{431}\) it must be noted that in tax avoidance cases such as *Canada Trustco*, the theoretical benefits of the certainty of highly formal rules are not what they may appear to be. The value of certainty championed by the Supreme Court in *Canada Trustco* was the dubious certainty of the effectiveness of a tax avoidance plan. What was at stake was not respect for ordinary business transactions and the property rights created by them. Nor was it certainty of the tax consequences that attached to the transactions undertaken and income earned by Canada Trustco. What was at stake was the certainty of measures (with no business purpose) undertaken to avoid lawful tax liabilities. To find for the Crown in *Canada Trustco*, the Supreme Court would not have visited a "sporadic

\(^{427}\) *Canada Trustco*, supra note 153 at paragraph 41.

\(^{428}\) Kennedy, "Form and Substance", *supra* note 313 at 1688

\(^{429}\) Ibid. See also, Atiyah and Summers, *supra* note 271 at 71.

\(^{430}\) Ibid.

\(^{431}\) For example, the Supreme Court of Canada referred to the value of certainty six times in the *Canada Trustco* decision. See Arnold, "Confusion Worse Confounded", *supra* note 151 at 178.
legal catastrophe” upon the taxpayer but merely prevented it from using artificial transactions with no business purpose to avoid legitimate tax liabilities; no legitimate, substantive, real commercial or business activity would be deterred by such a decision.

5.2.1.5. The “chilling” effect of standards

It is thought that standards have a “chilling” effect on behavior that is on the borderline of “substantive obnoxiousness”. In contract law, this may result in the reluctance of parties to contract if contract formation were governed by uncertain judge-made standards rather than highly formal rules – a result that is plainly contrary to the public interest. However, in tax cases (especially those cases involving tax avoidance) the analogous result is not against public policy. For example, some uncertainty about when a judge will find that a particular transaction lacks a business purpose or economic substance will likely have the effect of deterring some avoidance transactions that would have been entered into in the absence of the uncertainty created by such doctrines. The deterrence of avoidance transactions is a sound result, as it cannot be argued that tax avoidance is in the public interest. In fact, the use of highly formal rules in tax avoidance cases allow ‘the proverbial “bad man” to “walk the line”, that is to take conscious advantage of underinclusion to perpetuate fraud with impunity.’ Indeed, tax avoidance would be impossible without the latter attribute of formal rules.

5.2.1.6. The deterrence of desirable and undesirable conduct

Some argue that standards will deter both desirable and undesirable conduct. In tax law, this particular justification for formalism is cast as an argument that substantive doctrines will disallow both unintended tax benefits as well as benefits that parliament intended to confer on taxpayers. In fact, this is the very reason the Supreme Court of Canada rejected the business purpose doctrine advanced by the Crown in Stubart:

A strict business purpose test in certain circumstances would run counter to the apparent legislative intent which, in modern taxing statutes, may have a dual aspect. Income tax legislation, such as the federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain

432 Duncan Kennedy, “Form and Substance”, supra note 313 at 1696.
433 Ibid.
selected economic policy objectives. Thus the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no bond fide business purpose. Thus, by imposing a positive requirement that there be such a bond fide business purpose, a taxpayer might be barred from undertaking the very activity Parliament wishes to encourage. 434

However, such arguments ignore the fact that business purpose and economic substance standards have worked in the United States since the 1930s. It is noteworthy that there is a conspicuous absence of literature that criticizes American court decisions for using economic substance doctrines to disallow benefits that Congress intended to confer. Furthermore, the Canadian and UK experiences with substantive approaches in tax law, as brief as they were, also failed to fall into that theoretical trap. Therefore, the worry that desirable conduct will be deterred and legitimate deductions will be denied seems, in the words of Roscoe Pound, to be "more theoretical than actual." 435

5.2.1.7. The supposed deterrence of highly formal rules

Another argument in favour of highly formal rules is that if undesirable conduct can be deterred effectively by private vigilance, rules should alert actors to the potential danger to be avoided. An example of the latter is the penalty for failure to file a tax return by the statutory deadline or for fraudulent and grossly negligent misrepresentations in tax returns. 436 Such penalties should motivate taxpayers to file on time and accurately. Conversely, standards such as judge-made due diligence defences to late filing penalties of the kind created in Consolidated Canadian Contractors 437 alert taxpayers to the "possibility, however unlikely, of a legal remedy to save them from their sloppiness." 438 Of course, tax avoidance is one case where the deterrence of formal rules is non-existent. In fact, the opposite is the case, as formal rules or

434 Stubart, supra note 53 at 6322.
436 ITA, supra note 3 sections 162(1), 163(1), 163(2).
437 See note 400, supra.
438 Duncan Kennedy, "Form and Substance", supra note 313 at 1696.
formalistic statutory interpretation together with a formalistic approach to the characterization of taxpayer transactions are the twin pillars of tax avoidance.  

5.2.2. Subject matter and the choice between formal rules and standards

The co-existence in our legal system of both highly formal rules and highly substantive rules (also referred to as "standards") implies a choice between the two, and the practical consequences of choosing one or the other ought to be accounted for in the rational and principled design of a legal system. This, of course, includes those aspects of the legal system concerned with the control or elimination of abusive tax avoidance. However, before considering the particular case of tax law, it is useful to start at the more general level of the legal system as whole.

5.2.2.1. Transactions v. human conduct and the conduct of enterprises

Perhaps the earliest statement of the principles relevant to the choice between the two varieties of rules comes from Roscoe Pound in his Theory of Judicial Decision. Pound’s thesis is that highly formal rules of law, which are applied mechanically, are suitable for property or business transactions whereas standards, where application is not mechanical but proceeds on "intuition", are more adapted to human conduct and to the conduct of enterprises. Pound eloquently makes the case for standards in the administration of justice:

Nor need we be ashamed to confess that much that goes on in the administration of justice is intuitive. Bergson tells us that intelligence, which frames and applies rules, is more adapted to the inorganic, while intuition is more adapted to life. In the same way rules of law and legal conceptions which are applied mechanically are more adapted to property and to business transactions; standards where application proceeds upon intuition are more adapted to human conduct and to the conduct of enterprises.

Therefore, questions such as whether title to property has passed, whether the formal requirements for a valid will are present, whether there has been an offer and acceptance necessary to form a contract are best cast in the form of highly formal rules that are susceptible

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439 See Sherbaniuk, "Tax Avoidance", supra note 44.
440 Duncan Kennedy, "Form and Substance", supra, note 313 at 1701.
442 Ibid. at 951.
443 Ibid.
to mechanical application guided by the intelligence of a judge. Indeed, it is trite to state that the maintenance of the market requires the certainty provided by formalistic legal rules that can be applied mechanically, especially in contract law. However, highly formal rules provide little or no assistance when the latter situations are widened to include other facts that surround the core transactions such as whether, in the absence of a specified time for delivery, goods contracted for were delivered within a reasonable time or whether, in a valid will, the intention of the testator was that property pass to her nephew. In these situations, human conduct is engaged where matters of intention and reasonableness require the use of standards to determine the question.

Pound elaborates on the difference between highly formal rules (which Pound refers to simply as "rules") and standards:

Bergson tells us that what characterizes intelligence as opposed to instinct is "its power of grasping the general element in a situation and relating it to past situations." But, he points out, this power is acquired by loss of "that perfect master of a special situation in which instinct rules." Standards, applied intuitively by court or jury or administrative officer, are devised for situations in which we are compelled to take circumstance into account; for classes of cases in which each case is to a large degree unique. ... To take once more Bergson's discussion of intelligence and instinct, the machine works by repetition; "its use is mechanical and because it works by repetition there is no individuality in its products." The method of intelligence is admirably adapted to the law of property and to commercial law, where one fee simple is like every other and no individuality of judicial product is called for as between one promissory note and another. On the other hand, in the hand-wrought product the specialized skill of the workman, depending upon familiar acquaintance with particular objects, gives us something infinitely more subtle than can be expressed in rules.444

Simply put, unique circumstances call for standards. Standards, which are "that perfect master of a special situation", are perfectly suited for the novel transactions designed by determined tax lawyers. Finally, Pound makes the point that the choice of form must be guided by the substance or subject matter of the legal problem at hand:

In the administration of justice some situations call for the product of hands not of machines. Where the call is for individuality in the product of the legal mill – i.e., where we are applying law to human conduct and the conduct of enterprises – we resort to standards and to intuitive application. And the sacrifice of certainty in so doing is more theoretical than actual. The instinct of the experienced workman operates with assurance.445

In advocating a division of labour between highly formal rules and standards, Pound addresses a chief criticism of standards, namely that they compromise certainty, by pointing out that while this is, of course, theoretically possible, the theory is generally not borne out in practice. After all, lawyers are still able to give their clients opinions on whether their conduct falls below that

445 Ibid. at 952.
of the reasonably prudent person, or to take a common problem in tax law, whether their securities transactions are on account of income or capital. Both of these determinations apply standards to human conduct.

Admittedly, the latter situation involves business transactions but it is a perfect illustration of the application of the rules/standards dichotomy in tax law. Tax law is a not a primary body of law. It applies to transactions that are governed by the primary law of, in this case, contracts. The securities transactions themselves are governed by highly formal rules that determine ownership of securities and govern the contracts by which they are acquired and disposed of. Modern securities transactions are the paradigm of the repetitious and mechanical transactions that are amenable to governance by highly formal rules. However, in this instance, tax law requires a secondary legal operation to characterize those transactions as on account of capital or income before they can be properly taxed. This involves questions of human conduct, such as the intention of the taxpayer at the time of purchase to either hold the securities or to sell them for a profit at the first opportunity, the taxpayer’s pattern of dealing in securities generally, and the taxpayer’s educational, business, and employment background which may serve to colour whether he held the securities as current inventory or as a capital asset.\textsuperscript{446} The American business purpose and economic substance doctrines operate in exactly the same way. In \textit{Gregory}\textsuperscript{447} the validity of the transactions undertaken by Mrs. Gregory were determined by the primary law that governed them and the question for tax law was whether, \textit{for tax purposes}, transactions with no business purpose would be respected. To answer this question, Justice Hand devised appropriate standards to assess the conduct of the taxpayer (as well as the infinite variety of avoidance behaviour that would arise in future cases) and thus determine the tax treatment of the transactions.

In addition to Pound’s division of legal labour between rules and standards along the lines of the subject matter of transactions and human conduct, respectively, highly formal rules are suited for the advancement of many social welfare, public policy, and economic goals. The realization of such policies through law would in many cases not be possible, or at least would be

\textsuperscript{446} See e.g., \textit{Arcorp Investments Limited v. Her Majesty the Queen} 2000 DTC 6690 (F.C.T.D.).

\textsuperscript{447} \textit{Gregory}, supra note 78.
grossly inefficient if they were not implemented in the form of highly formal rules. Atiyah and Summers argue that "the predictability, uniformity, and publicity of rules and their administration is required to secure the public confidence and cooperation necessary for the realization of goals of this kind, particularly redistributive schemes of public benefit. Imagine, for example, the difficulties of trying to run a modern welfare state, including such complex matters as the tax system and the social security system, without any resort to rules!" As to the question of whether such rules should be highly formal rules or standards, they argue that highly formal rules are required because they must be administered by relatively minor officials, and the public is less tolerant of rules of low mandatory formality where those rules are to be applied by a host of minor administrative officials rather than judges. Although their argument has some relevance in tax law, as tax law is largely applied by minor officials such as auditors and collections officers, their argument has less force when one considers that all the decisions of those officials are subject to review by superior court judges in a trial de novo. Further, the decisions of those judges are appealable to the Federal Court of Appeal and onward to the Supreme Court of Canada. Therefore, the rules of taxation are, in their application by the legal system, no different than the rules of tort, criminal, property, and contract law. Presumably, therefore, taxation is not equivalent to public goals such as "public welfare, public health, environmental control, public education, social security, as well as more traditional goals such as the common defence, the provision of a postal service, and the like" where highly formal rules may be more justifiable.

5.2.2.2. The medium is the message

Another aspect of the choice between highly formal rules and standards is that the choice between the two is to a significant extent driven by the values or vision of the world - or of the various activities that are the subject matter of law - we wish to create in and through the legal system. In choosing a form (rule or standard) through which to achieve a goal "we are almost always making statement that is independent or at least distinguishable from the statement we

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448 Atiyah and Summers, supra note 271 at 74.
449 Ibid.
450 Ibid.
make in choosing the goal itself." As discussed in chapter 4, the value promoted by standards is altruism and the value promoted by formalistic rules is individualism. The banishment of substantive standards in tax law is the promotion of individualism over altruistic values such as fairness and equality of treatment among taxpayers. The tax avoidance cases of the Supreme Court of Canada since the late 1990s with their emphasis on formalistic rule-based reasoning promote the value that individual ingenuity should entitle a taxpayer to avoid tax obligations that would otherwise be imposed and to cast his burden on others. The individualistic vision of society has been a thread in Anglo-Canadian tax jurisprudence since the nineteenth century. The foundation for formalistic jurisprudence is the decision of the House of Lords in *Duke of Westminster* where Lord Tomlin made is famous statement (reproduced again for convenience):

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

Lord Tomlin’s words “ingenuity” and “ordering” of “affairs” refer to the entrepreneurial activities of the self-interested and self-reliant actor. The Supreme Court of Canada has followed the same principle. In reference to the Minister’s argument that regard must be had to the economic realities of the transaction and the unfairness to other taxpayers that results from a formalistic approach, the Supreme Court of Canada stated in *Shell Canada* that:

> [T]his Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts’ role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way.

Championing a curious legal entrepreneurialism, the court casts the matter in terms of taxpayer choice and therefore gives primacy to the will of the individual as choosing his destiny in relation to the ITA. However, the plain fact is that most taxpayers cannot structure their transactions in a way that separates economic substance from legal form and thus avoid taxes. For them it is not a matter of choice. Although financial ability to pay for advice plays a part, for

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451 Kennedy, “Form and Substance”, *supra* note 313 at 1710.
452 Ibid.
453 See discussion, *supra*.
454 *Duke of Westminster*, *supra* note 65, at 19-20 [emphasis added].
most taxpayers it is largely a matter of what is legally possible given their legal status and circumstances. For example, tax avoidance is unavailable to employees who have tax deducted at source. Shell Canada is a vivid illustration of the way formalistic reasoning promotes individualism at the expense of altruistic values like fairness, equality, and sharing of the fiscal burden of government and civil society. The problem with a tax jurisprudence devoid of any substance over form standards is that it promotes values that are nowhere acknowledged as an underlying policy or goal of the tax system and compromises those that are. Therefore, the values intrinsic to substantive standards are consistent with the ITA while the values intrinsic to highly formal rules are in opposition.

5.3. ARE COLLATERAL STANDARDS APPROPRIATE IN TAX LAW?

5.3.1. The Failure of the Formalistic Approach

It goes without saying that primacy of rules and their observance by the public are the values commonly associated with the rule of law. It is important to point out that standards are a species of rule and are therefore not an affront to the rule of law. However, it is true that the more formal rules are, the more they constrain official arbitrariness, ensure that like cases are treated alike, bring certainty and predictability to social and commercial life and facilitate self-governance by citizens who are able to know in advance the rules within which they are required to act. It is the belief that standards in tax law compromise the latter benefits of formal rules that leads to the horrified reaction that standards often receive from members of the private tax bar and from judges in the UK and Canada. It is thought that standards “replace reliance on the rules with a one way law favoring the government, administered at the discretion of government agents, and dependent upon the taxpayer’s purposes or thoughts rather than his actions. After all, how can people fill out their tax returns unless the law is clear?”

However, the “action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally-guided and equally

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455 Ibid. at 71.
456 See discussion supra.
specialized taxpayer reaction" fostered by detailed, highly formal rules has done everything to make the ITA opaque and completely inaccessible to the ordinary citizen and cannot seriously be said to promote the rule of law. This is the unhappy consequence of formalism in tax law: detailed, formalistic statutory rules are required because legislative drafters are writing for a judicial audience that construes the ITA narrowly. Drafters who cannot rely on the judiciary to use purposive interpretation in a collaborative manner must respond with a profusion of detail. In a reflexive process, that very detail becomes a reason to adopt a formalistic interpretation which in turn spurs more detail. In the words of Justice Iacobucci, “attention must be paid to the fact that the Act is one of the most detailed, complex, and comprehensive statutes in our legislative inventory and courts should be reluctant to embrace unexpressed notions of policy or principle in the guise of statutory interpretation.” The formalistic approach to tax law has been a failure because, despite the undesireable opacity caused by the profusion of detail, taxpayers can still “manipulate the rules endlessly to produce results clearly not intended by the drafters” causing inefficiency, revenue loss and the demoralization of others. Stanley Surrey was correct when he wrote (in the context of the American judge-made substance over form doctrines) that the use of less formal standards would “save the tax system from the far greater proliferation of detail that would be necessary if the tax avoider could succeed merely by bringing his scheme within the literal language of substantive provisions [i.e., highly formal rules] written to govern the everyday world.” It is the latter insight that prompted the Canadian parliament to enact the GAAR and judges in the US and UK to rely upon anti-abuse rules as the business purpose and economic substance tests. But what are the attributes of anti-abuse rules and why are they necessary and appropriate in tax law?

5.3.2. The attributes of anti-abuse rules

Anti-abuse rules, whether a statutory GAAR or judge-made doctrines, have certain salient features, as concisely summarized by David Weisbach (who calls them “rules” rather than “standards”):

458 See Stubart, supra note 53, at 6324.
459 65302 British Columbia Ltd., supra note 191 at paragraph 51.
A typical anti-abuse rule allows the government (and only the government) to override the literal words of a statute or regulation. Instead, the government may require a "reasonable" tax result if the taxpayer enters into a transaction with a principal purpose of reducing tax liabilities in a manner contrary to the purposes of the statute or regulation, even if the transaction otherwise literally complied with the rules.  

The most important feature of anti-abuse standards, the feature that gives them the ability to effectively address abusive tax avoidance, is their substitution of substantive standards for formalistic rules. The disadvantage of highly formal rules in tax law is that they cannot prevent abusive avoidance without being unduly complex. Therefore, the use of anti-abuse standards together with rules allows "the tax system to have the advantages of reasonably simple rules without the disadvantages." Simply stated, standards prevent the tax law from becoming too complex. Furthermore, given the pragmatic and functional realities of the legal system and the distinct uses of highly formal rules and less formal standards, is a substantive form over substance doctrine in tax law more appropriate than the traditional Anglo-Canadian insistence on the formalistic interpretation of detailed statutory rules? The remainder of the analysis in this section is devoted to this question.

5.3.3. The critical difference between highly formal rules and standards

According to Lawrence Kaplow, the important difference between rules and standards is whether the content of the law is determined before individuals act. Commensurate with their high degree of content formality, rules determine the content of a law before individuals act whereas with standards, with their lower degree of content formality, the precise content of the law is determined after individuals act. This is the critical feature of standards that gives them their inherent flexibility in meeting the infinite variety of fact situations that arise from human conduct, or in the case of tax law, the infinite variety of tax avoidance plans created by taxpayers' advisors. Therefore, rules and standards differ only in the level of uncertainty the fore

462 Weisbach, "Formalism in the Tax Law", supra note 374 at 860.
463 Ibid. at 861.
464 Ibid. at 862.
465 Ibid.
individuals to bear when they act. The very strength of standards, that their content is determined ex post, has been criticized. A common refrain against the use of standards in Anglo-Canadian jurisprudence is that they go against the “intuition” that taxpayers must be certain of their tax liabilities. However, the intuition makes little sense, as there is no reason why our tax liabilities should be more certain that our constitutional rights, which are in the form of general standards with wide interpretive leeway afforded to judges.

5.3.4. The unique nature of tax avoidance justifies the use of anti-abuse standards

Building on Kaplow’s idea that the content of standards is determined ex post, David Weisbach makes an insightful argument for the necessity of standards in tax law, pointing out that the exclusive reliance on rules will serve to make more common the previously uncommon avoidance transactions that were not covered by highly formal statutory rules (an omission that was tolerated because the cost of those uncommon transactions was small relative to the cost of formulating and administering rules of sufficient complexity to cover them). In non-tax jurisprudence, an analysis of the costs and benefits of the complexity of rules will likely suggest that laws should be drafted to fit common circumstances. A consequence of this is that uncommon circumstances will not be regulated, but this is tolerable because those circumstances are uncommon and therefore under-regulation of them is not costly. That is, the cost of fitting the law to uncommon transactions or circumstances will, at some point, exceed the costs of letting rare transactions slip through the statute, so economic considerations dictate that rare transactions go unregulated. This calculus holds true in areas of law such as tort, environmental regulation, and safety regulation because the uncommon circumstances will likely remain uncommon (assuming technology remains constant). However, the calculus breaks down in tax law because transactions that were uncommon when rules to cover common,

467 Weisbach, “Formalism in the Tax Law”, supra note 374 at 866. (Rules and standards also differ in with respect to promulgation costs, which are higher for rules because the detailed content of the law must be determined at the time of promulgation and enforcement costs which are higher for standards because content is determined at the time of application and enforcement).
468 Ibid. at 975-976.
469 Ibid.
470 Ibid. at 867-868.
471 Ibid. at 868.
472 Ibid. at 869.
everyday business transactions were promulgated will become common as an ever-increasing number of taxpayers, aided by professionals marketing the tax shelter to them, employ those transactions to reduce their taxes. One reason why tax law is relatively unique in this regard is its focus on the legal form of transactions, which allows taxpayers to adopt different forms for transactions while keeping their economics constant.473 Another reason is the culture of tax avoidance.474 In Canada, the culture of tax avoidance, nurtured and reinforced by a long line of judicial decisions going back to the Duke of Westminster and earlier into the nineteenth century, that encourages the formal manipulation of transactions to exploit formalistically interpreted taxation provisions in order to avoid taxes in ways that were unintended by legislators. Unlike standards, rules are not good at regulating uncommon transactions because their content is determined ex ante.475 On the other hand, standards, the content of which is determined ex post, allow taxpayers fewer opportunities to take advantage of imperfections in the formulated law. For highly formal rules to achieve the same level of coverage as standards, they would need to be unduly complex to the point of being cost ineffective (not to mention virtually impossible to administer in practice).476 Anti-abuse standards are an elegant solution to the problem of certain, but unduly complex highly formal rules on the one hand and uncertain but simple standards on the other.

As noted in section 5.2, formalistic reasoning is justified when there are grounds for believing that the relevant substantive considerations were or could have been brought before some other body at some other time. In the case of tax avoidance transactions, this is impossible. The legislature could not possibly have legislated statutory rules with consideration of transactions that will, in the future, be designed to avoid those very rules. By definition, avoidance transactions cannot be known until the rules they are designed to avoid are known. Accordingly, formalistic reasoning is not justified in tax avoidance cases. Substantive reasoning employing the use of substance over form standards is necessary to account for the particular circumstances of the very unusual and highly variable facts presented avoidance transactions.

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473 Ibid.
474 Ibid. at n.25.
475 Ibid at 870.
476 Ibid. at 871, 876.
5.3.5. Anti-abuse standards should be one-way laws in favour of the government

The anti-abuse standards discussed in chapters 3 and 4, the GAAR and the business purpose and economic substance doctrines, are both one-way laws in that they allow only the government to depart from the literal language of the statute but not the taxpayer. This feature has led many to argue against such standards on the basis of unfairness. However, the one-way nature of anti-abuse standards is justified because there is a unique systemic aspect of tax law that requires one-way standards in favour of the government. One way rules are necessary to level the playing field with taxpayers because the government suffers a distinct first-mover disadvantage:

Think of tax law promulgation as a game. The government has the first move, in which it must determine the content of the law. The taxpayer then determines her transactions. ... Given this game, the taxpayer has a distinct advantage over the government, because the taxpayer acts with complete knowledge of the government’s decisions while the government can only guess at the taxpayer’s decisions. One way rules level the playing field by reducing the taxpayer’s ability to take advantage of the situation.477

Therefore, standards allow the government to reduce its first-mover disadvantage because, as their content is determined ex post, the government effectively refuses to move first. A functional advantage of one-way anti-abuse rules is that they retain the advantages of rules in most circumstances.478 In normal circumstances, taxpayers will be doing business as usual and will not be engaging in abusive tax motivated transactions lacking a business purpose and/or economic substance and as such they will be governed by the usual rules of the tax code. However, when taxpayers take advantage of the simple rules that were drafted, to use Surrey’s phrase, “to govern the everyday world”, by engaging in abusive tax avoidance, the one-way anti-abuse standards prevent the unusual transaction and stop it from becoming common.479 Therefore, the goal of anti-abuse standards is to “identify violations of the implicit pact that uncommon transactions will not become common in response to simple rules.”480

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477 Ibid at 878.
478 Ibid.
479 Ibid. at 879.
480 Ibid. at 880.
5.3.6. Anti-abuse standards should look to purpose

A second feature of anti-abuse standards is that they look to purpose in two respects: the purpose of the taxpayers' transaction and the purpose of the statutory provision under which the unintended deduction or other tax benefit is conferred. Both the Canadian GAAR and the American substance over form doctrines share this feature. The relevance of purpose in such standards allows them to focus on a narrower range of transactions and to distinguish between legitimate business or commercial transactions on the one hand and abusive transactions which are intended to take advantage of simple rules on the other. Needless to say, this aspect of anti-abuse standards and the fact that their content is determined ex ante have attracted criticism from taxpayers' advisors.

5.3.7. Criticisms of anti-abuse standards

The criticisms of anti-abuse standards, be they in the form of a statutory GAAR or a judicial substance over form standard, are similar and generally alarmist. Some practitioners felt that the GAAR was unconstitutional and a violation of the rule of law and was a tool that the courts would be reluctant to use.481 The rule was also criticized for its theoretical uncertainty and the power it would give to the revenue authorities.482 Others thought that the rule would prevent them from giving meaningful advice to their clients.483 However areas of law such as tort and constitutional law are replete with standards at least as uncertain as the GAAR and the American doctrines and lawyers practicing in those areas seem to have no difficulty giving opinions. As one American tax lawyer has written, "I believe that sophisticated practitioners are undoubtedly aware when a transaction is structured to achieve a tax result inconsistent with its economic substance."484 Moreover, the greatest uncertainty is reserved for transactions that are highly abusive. The application of the ITA to ordinary business transactions that were entered

into without any tax purpose does not face any appreciable degree of uncertainty from anti-abuse standards.

It is functionally necessary for the system of tax law to have anti-abuse standards such as the GAAR and the American substance over form doctrines. The functional limitations of the parliamentary process that drafts ex ante formal rules in statutes that are inherently inflexible require that courts undertake the task of preventing tax avoidance by formulating and applying flexible substance over form standards to address transactions that were impossible for the legislature to anticipate. Because of the government’s first-mover disadvantage, it is impossible for parliament to address the problem. As a functional necessity, that task must fall to judges.

5.4. Substance over Form in Non-Tax Jurisprudence

Much of the criticism of anti-abuse standards in tax law conveniently ignores the fact that such standards are not unique to tax law. Outraged voices decrying the unconstitutionality and dictatorial nature of substance over form doctrines seem crudely exaggerated when heard against the knowledge that non-tax jurisprudence employs essentially the same anti-abuse solutions that they denounce in tax law. Both property and contract law may be viewed as formalistic in their nature and origin. Generally, questions such as rights and obligations under a contract or the ownership of land or chattels are matters of legal form, to be determined with reference to the terms (the words) of the documents and instruments evidencing transactions and creating rights, duties, and transfers of assets. However, even in these areas of law, jurisprudence has developed substance over form doctrines to temper the abuse of highly formal rules and account for substantive reasons for making decisions when it is evident that there is no other time or place in the legal system where such reasons may be considered. Contract law has developed the doctrine of good faith to prevent economically powerful parties from depriving the weaker party of the benefit of the contract even though the former is not formally in breach of any express contractual term. Similarly, property law has developed the concept of the constructive trust to give persons an interest in property in circumstances where, as a matter of substance, they have contributed economically to the ability of another to formally acquire or maintain property where
the former would otherwise have no formal legal interest in it. In the same manner, employment law has developed the concept of constructive dismissal to deal with situations where an employee formally resigns his position but was dismissed in substance.

5.4.1. Contract law

The formalism of nineteenth century contract law has, since that time, increasingly given way to substantive doctrines that have prevented one party from exploiting form to the detriment of the other party. One American treatise on contract law has called this development the "erosion of the rigid rules of the late nineteenth" and the "narrow scope of social duty which it implicitly assumed. In our own century we have witnessed what it does not seem too fanciful to describe as a socialization of our theory of contract." In contract law, one of the major manifestations of the "erosion of the rigid rules of the nineteenth century" is the concept of good faith and fair dealing in the performance of contracts, which is essentially a substance over form anti-abuse doctrine similar to the anti-abuse standards employed in tax law. The functional, legal systemic needs that the doctrine of good faith satisfies and the criticisms it consequently attracts are remarkably similar to those surrounding substance over form standards in tax law:

[T]he resilience of the concept [good faith] testifies to its utility. Good faith is a flexible and pragmatic concept which addresses inherent inadequacies in rights-conferring language. Rights are not absolute -- they are tempered by responsibility and are not to be abused. However, applying good faith on an ad hoc basis with inconsistent views regarding its legal basis gives legitimacy to the critics' complaints of unpredictability, which is so dreaded in the commercial world.

Therefore good faith addresses inadequacies in rights conferring language, or in other words, formalistically construed contractual provisions. Like statutory provisions, contractual rights are susceptible to abuse and that the concept of good faith prevents such abuse. As such, the good faith doctrine in contract law serves the same purpose in contract law that anti-abuse standards serve in tax law.

486 David Weisbach, "Formalism in the Tax Law" supra note 374 at 884.
A term requiring good faith performance may be implied by operation of law or implied in fact as an incident of the intentions of the parties. In the former category, courts impose a duty of good faith because the nature of the contract or relationship is one with an inherent or predicable vulnerability of one party that is present at the time of contracting. The implication of a term of good faith balances out the unequal positions of the parties. Once implied, the term will technically restrain the conduct of both parties but in practice only the dominant party’s behavior will be at issue. At first glance it may appear incongruous to draw an analogy between the doctrine of good faith in contract law and anti-abuse rules which favour the government because the government appears to be the dominant party in its relationship with taxpayers. However, in the game of tax avoidance the reverse is true. As discussed above, the government suffers from a distinct first-mover disadvantage whereas taxpayers act with complete knowledge of the government’s position when designing their tax avoidance plans. Therefore, just as in contract law, a substantive anti-abuse doctrine is required to equalize the relative knowledge discrepancy between the government and taxpayers.

James McCamus has, from reported decisions, derived three categories of good faith. According to McCamus, good faith might be defined in relation to (1) the duty to exercise discretionary powers conferred by a contract reasonably and for their intended purpose; (2) the duty to cooperate in securing performance of the main objects of the contract; and (3) the duty to refrain from strategic behavior designed to evade contractual obligations. The latter category of conduct closely resembles the legal avoidance that is the foundation of abusive tax avoidance.

5.4.2. Employment Law

Perhaps the most well known substance over form doctrine in employment law is the doctrine of constructive dismissal. In constructive dismissal cases, the employee is not formally dismissed by the employer but rather, as a matter of form, resigns. However, where the

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489 Ibid.
490 Ibid.
491 See section 5.3.5, supra.
employee resigned because of the employer’s conduct, the employee is entitled to consider herself constructively dismissed and consequently sue to the employer for wrongful dismissal. In *Faber v. Royal Trust Co.*, Justice Gonthier wrote:

Thus, it has been established in a number of Canadian common law decisions that were an employer unilaterally makes a fundamental or substantial change to an employee’s contract of employment – a change that violates the contract’s terms – the employer is committing a fundamental breach of the contract that results in its termination and entitles the employee to consider himself of herself constructively dismissed.

The doctrine has been extended to situations where the employer’s treatment of the employee makes continued employment intolerable. An illustrative case involves an employee of Xerox who resigned after 12 years of service when he suddenly found himself subordinate to an abusive supervisor. In another case, an employee had been constructively dismissed by an employer who unjustifiably criticized her, leveled vague and unfounded accusations against her, and created a hostile and embarrassing work environment. The doctrine of constructive dismissal assists employees in situations where a focus on the legal form of the relevant employment transactions would not allow the employee to sue for wrongful dismissal because, as a matter of form, the employee resigned and was not dismissed. The doctrine looks to substantive considerations of the circumstances of the case to determine whether the conduct of the employer "demonstrates an intention no longer to be bound by" the employment contract, either because of the employer’s abusive conduct or because the breach of a fundamental term of the employment contract. Obviously, such an individualized consideration of the case cannot be made under a statutory or other regime of highly formal rules. Therefore, substantive standards developed by judges step in to fill the legal gap that is left by formalism because justice requires no less.

5.4.3. Property Law

Property law has developed the substance over form doctrine of constructive trust to deal with cases where the legal form of the relationships between persons deny property rights to one
of them in a situation where substantive considerations suggest that the denied party should have some interest in the property in question. Absent the substantive doctrines, property rights will be determined by the usual formal rules such as registration as the owner of land in fee simple. In *Peter v. Beblow* a couple cohabited in a common law relationship for 12 years in a house legally owned by Mr. Beblow. During their cohabitation Mr. Beblow was employed outside the home and used his remuneration from that employment to pay-off his mortgage during the course of their relationship. Ms. Peter maintained the home and cared for the children of their blended family without any pay. The Supreme Court of Canada found that Mr. Beblow had been enriched by Ms. Peter’s housework and childcare and that there was no juristic reason for the enrichment. Ms. Peter’s contribution allowed Beblow to save substantial sums of money which he used to pay off the family home and acquire other property and therefore Ms. Peter’s contribution was connected to the home and other property formally owned by Beblow such that Ms. Peter was entitled to a legal interest in that property.

The three doctrines from non-tax jurisprudence discussed above are all instances where judges have sought to temper the unfair results that arise when one party to a relationship exploits legal form to his or her advantage. They amount to judicial corrections of abuses of form in the interests of justice and fairness. If the courts had taken a formalistic approach, there would not have been any recourse for the aggrieved party. The doctrines demonstrate that in our legal system formal legal relationships are not sacred and that substantive considerations often temper legal form. This is the case even in property, contract, and employment law, three areas that involve commercial relationships and transactions and are therefore amenable to the highest degree of formality but where the uncertainty wrought by substantive standards is a tolerated and accepted part of the law. It should be no different in taxation.

5.5. **Conclusion**

Substance over form doctrines in tax law are consistent with the doctrines in other areas of law because they recognize that it is in the interests of justice and fairness the abuse of formal rules must be tempered with doctrines that anchor law in the real world of substance. In tax jurisprudence, substance over form doctrines recognize that the government faces a first-mover disadvantage in that it promulgates formal statutory rules with no ability to know in advance the
myriad forms of avoidance transactions taxpayers will subsequently design in response to the enacted rules. Taxpayers then have the advantage of a fixed text in response to which tax avoidance transactions may be designed. Substantive doctrines in tax law recognize that with respect to tax avoidance transactions, it is not possible that the relevant substantive considerations can be accounted for at any time other than adjudication before a judge because, by definition, avoidance transactions cannot be known until the rules they will be designed to avoid are known. Consequently, formalistic approaches in tax law have little justification and there is a great need to develop flexible judicial doctrines to prevent the abuse of formal rules.
6. Conclusion

The history of Canadian tax jurisprudence is one of doctrinal instability with the Supreme Court of Canada equivocating between a formalistic and substantive approach to tax avoidance cases. The very fact of doctrinal instability suggests a lack of conviction among the justices of the court about whether a substantive or formal approach to tax cases is the most appropriate. A similar equivocation is evident in the jurisprudence of the UK House of Lords. By contrast, American courts have consistently applied a substantive approach since the 1930s. The remarkable doctrinal tension in tax law shows that formalism is not the only viable and credible approach. It also naturally raises the question of which of the two doctrinal alternatives should prevail and how ought judges to go about finding the correct principles to solve the form and substance problem in tax law. In other words, what is the right answer to the form-substance problem and how do we know that it is the right answer?

Ronald Dworkin’s theory of law as integrity presents an attractive analytical framework with which to approach the form-substance problem using a theory of judicial reasoning that is both descriptive and prescriptive. Law as integrity allows one to approach the problem as a judge would when encountering the problem in the context of adjudication, engaging in a constructive interpretation of the law to find principles that fit with the contemporary community values, norms and political morality that are expressed in the whole of the community’s legal record. Accordingly, law as integrity is amenable to practical solutions to legal problems and therefore fits within the umbrella of practical reasoning – an approach that uses diverse intellectual sources to arrive at practical solutions to legal problems.

In addition to the methodological virtues of Dworkin’s theory, it has substantive virtues as well. Law as integrity strives to make the solutions to legal problems, including hard cases, integral with the larger body of the law as a whole. Given that Canadian tax jurisprudence suffers from a deplorable lack of stability and consistency, it badly needs an injection of integrity. Law as integrity seeks out a solution that is horizontally consistent with the values,
norms and political morality of the community as expressed in the legal record as a whole. Therefore, the measuring stick with which to assess the rightness of a legal doctrine or principle or approach to reasoning is not theoretical or political. Rather, it is law itself that embodies the norms, values, and political morality against which legal solutions are measured and with which they should be consistent. The ideas of justice and fairness have no absolute meaning or content. However if law is horizontally consistent with community norms, values, and political morality, then it is sure to be regarded as just and fair. Conversely, any legal doctrine that is not horizontally consistent is bound to be regarded as unjust and unfair.

Formalistic Canadian tax jurisprudence is not horizontally consistent with the norms, values, and political morality of the community. A formalistic approach in tax avoidance cases has implications that run counter to the political morality embodied in tax law itself. It facilitates tax avoidance by limiting parliamentary enactments to the narrowest construction of their words, an outcome that is undemocratic because it is the clear intention of a parliament that enacted a GAAR to control tax avoidance. Furthermore, formalism promotes individualism in tax law by allowing individuals to effectively contract out of the public law regime of taxation by allowing them to engage in the private ordering of their affairs to avoid the legal obligations imposed by the ITA with the consequence that some individuals are able to pay tax voluntarily when there is nothing voluntary about the ITA. Formalism also gives rise to inequality and unfairness in that it allows taxpayers who earn their income through business to cast their fiscal burden on others like employees who, due to their legal status, have no real opportunity to engage in similar behavior. These implications expose the laissez faire and libertarian political basis of formalistic jurisprudence, which is contrary to the plainly collectivist and altruistic foundations of the ITA, as expressed in the notion that everyone should pay their fair share of the national fiscal burden and that those with greater wealth should contribute a greater proportional share.

Formalism also gives rise to bad tax policy. It promotes abusive tax avoidance and prevents judges from formulating viable doctrines to prevent it; indeed, formalism leaves judges with no alternative but to condone abusive tax avoidance. Furthermore, it prevents legislative ant-avoidance measures, such as the GAAR from having meaningful effect.
Apart from the tax policy and political implications, formalism has philosophical implications in that it weakens the law as a social institution by trivializing it to the point that it becomes merely symbolic and commodified, losing its traditional character as governing the community for the common good. Rather, it becomes a tool owned by those individuals who are legally and financially best positioned to take advantage of the avoidance opportunities presented by formalism.

The norms and values engaged by the form-substance problem can be gleaned from the way the legal system as a whole treats formal and substantive rules and approaches. The legal system uses two varieties of rules to accomplish its objectives: highly formal rules (or formalistic approaches generally) and comparatively substantive standards (or substantive approaches generally). Both varieties of rules have distinct functions to perform in a legal system and they are respectively suited to different kinds of legal problems. The primary justification for resort to highly formal rules and formalistic approaches in law are pragmatic and functional, in that the legal system needs to make decisions in an orderly manner. Formalistic reasoning is justified when there are grounds for believing that the relevant substantive considerations were or could have been brought before some other body at some other time. Where this assumption cannot be made, formalistic reasoning lacks justification and the law relies on substantive reasoning. For example, the rules of tort law are largely substantive in nature because it is impossible to account for the infinite variety of fact situations that arise from human conduct in advance of human action through the use of highly formal rules. The nature of the legal problems solved by tort law requires the use of more substantive rules (standards), the content of which is determined ex ante. That is, reasons of substance must be accounted for by a judge in the context of adjudication after citizens act. Absent this, there is no way for the legal system to account for reasons of substance that bear upon the legal problem; it is the nature of the problem that it requires substantive standards. Therefore it is a fundamental norm or value of the legal system that those legal problems that involve infinitely variable human conduct that cannot be anticipated by the legislature (or other legal officials who are empowered to formulate highly formal rules) are best solved through the application of substantive judicial standards. Tax avoidance cases involve infinitely variable human conduct that cannot be anticipated by the legislature and therefore their legal treatment should be consistent with the latter practice.
In addition to the pragmatic and function need for substantive standards law, the legal system generally chooses between formal and substantive approaches on the basis of the subject matter to be governed. Highly formal rules are generally used to govern repetitive and mechanical every-day transactions such as business and commercial transactions. Such transactions are largely identical and are susceptible to ex ante anticipation by rule-makers; it is essential for subject matter to have this attribute if it is to be regulated by highly formal rules. On the other hand, substantive standards are used to govern the conduct of individuals and enterprises, as such conduct is infinitely variable and cannot be anticipated ex ante. The division of labour between highly formal rules and comparatively substantive standards reflects another norm of a legal system that seeks to achieve justice, fairness and effectiveness. Applied to tax law, tax avoidance schemes are, by definition, rare, novel, and infinitely variable transactions that engage the conduct of individuals and enterprises and sound be governed by substantive standards rather than formalistic approaches.

The approach most suitable for tax avoidance cases is the use of substantive standards, as that approach is horizontally consistent with the way the legal system as a whole treats similar problems. In tax law, substantive approaches usually employ anti-abuse rules, which can been judge-made (as is the case in the USA) or legislative (as is the case with the Canadian GAAR). However, legislative anti-abuse rules, because they are statutory, are inherently more rigid than judge-made rules and may be interpreted by formalistic courts to the point of de facto nullification. The Supreme Court of Canada’s decision in Canada Trustco suggests that the Canadian GAAR has suffered the latter fate. Therefore, the solution to the form-substance problem is ideally a judicial one. Judges must conceive of their role as one that prevents rather than encourages tax avoidance as that role is integral with the values expressed in the legal record as a whole. Once judges adopt an approach to tax cases that is integral with the legal record as a whole, they are empowered to formulate the appropriate substantive collateral doctrines such as the American business purpose doctrine or other similar anti-abuse rules to prevent the abuse of formal statutory rules by purely tax motivated transactions.

See e.g. Consolidated Canadian Contractors, supra note 400.
Anti-abuse rules are justifiably one way rules in favour of the government to account for the fact that the government suffers from a first-mover disadvantage in the tax avoidance game. It must legislate without knowing the avoidance transactions taxpayers will come up with after the fact. Taxpayers have the advantage of knowing the government’s legislative move and dynamically designing transactions around the fixed and unchangeable legislative rules. In this way, anti-abuse rules prevent the abuse of formal statutory rules that were written to govern the every-day world by preventing uncommon tax motivated transactions. Regular, every-day business transactions will not be subject to the relative uncertainty of anti-abuse rules. The latter will be governed by the formal rules of the tax code so that the ITA will receive a largely formalistic judicial treatment. However, uncommon, tax motivated transactions with no business purpose are subject to anti-abuse standards. To achieve the differentiation between regular transactions and uncommon avoidance transactions, anti-abuse rules look to the purpose of the transaction and the purpose of the legislative provision in question.

Finally, a substance over form approach in tax law that prevents the abuse of formal rules is horizontally consistent with similar approaches formulated by judges in the areas of contract, property, and employment law.

Substantive doctrines in tax jurisprudence would depart from old British precedents like the *Duke of Westminster* but they are consistent with the norms, values, and political morality embodied in contemporary legal practice and they make tax law integral with the greater body of law. Unlike substantive doctrines, formalistic doctrines in current Canadian tax jurisprudence are a legal aberration in the Canadian legal system. Substantive doctrines are the product of a constructive interpretation of the legal record as a whole, which imbues them with the resonance of the community’s contemporary vision of justice and fairness and also with the echo of that vision into the future. This honourable outcome cannot be achieved unless courts depart from “a narrow line of past decisions in search of fidelity to principles conceived as more fundamental to the scheme as a whole.”

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