

THE GENERAL ANTI-AVOIDANCE RULE:  
HAS IT CHANGED THE FACE OF TAX AVOIDANCE?

by

JANIE TREMBLAY

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Department of Law

The University of British Columbia  
Vancouver, Canada

Date April 4, 1996

## ABSTRACT

Since time immemorial, there has been a (continual) duel between the taxing authorities and taxpayers. In Canada, this duel between Revenue Canada and taxpayers has become even more fierce over the past fifteen years. As a result, the Minister of Finance enacted the General Anti-Avoidance Rule ("GAAR") (section 245 of the *Income Tax Act*) which officially came into force on September 13, 1988. GAAR is intended to limit the boundaries of acceptable tax avoidance, but in a climate in which the ability to reduce taxes by use of tax avoidance schemes is a source of great pride, the far reaching scope and uncertain application of GAAR make it the most controversial section of the *Act*. These features also make GAAR the most promising tool by which to curtail tax avoidance. Accordingly, the purpose of this thesis is to assess whether or not GAAR has changed the face of tax avoidance, and if so, how?

In addressing this issue, the thesis takes the reader through a step by step analysis of GAAR's genesis. It starts with a review of former subsection 245(1) and the judicial anti-avoidance doctrines existing prior to GAAR. This is followed by an analysis of the policy turmoil, having fairness as its core issue, which led to the rule. The conclusion will include an assessment of the final product. This step by step analysis enables the reader to understand the shortcomings of the *pre*-GAAR methods of dealing with tax avoidance and, subsequently, GAAR's potential. However, as all judicial decisions relating to GAAR are pending, inference from the principles established in recent tax avoidance decisions will be the basis for assessing GAAR's potential to circumscribe effectively tax avoidance.

Despite the lack of case law interpreting GAAR, this thesis suggests that current judicial trends reveal that GAAR's success is subject to the somewhat aleatoric judicial system of a society which encourages tax avoidance. It is submitted that, in the end, GAAR has not changed the face of tax avoidance; it has simply modified the way taxpayers may reduce their tax liability and limited the class of people who can avail themselves of the benefits of tax avoidance. Certainly, GAAR does not contribute to the government's espoused policy of fairness in taxation.



## TABLE OF CONTENTS

Abstract	...	ii
Table of Contents	...	iv
Acknowledgement	...	vi
Dedication	...	vii
INTRODUCTION	...	1
Chapter One	Legal Antecedents of the General Anti-Avoidance Rule	...6
	A. Former Subsection 245(1) of the <i>Income Tax Act</i>	...7
	1. Meaning of the Word "Deduction"	...9
	2. Meaning of the Phrase "Disbursement or Expense made or incurred in respect of a Transaction or Operation"	...12
	a) "Disbursement" or "Expense"	...12
	b) "Transaction" or "Operation"	...15
	3. Meaning of the Words "Unduly" or "Artificial"	...16
	4. Assessment of the Effectiveness of Former Subsection 245(1)	...20
	B. Judicial Doctrines of Tax Avoidance	...22
	1. Ineffective Transactions	...23
	2. Substance over Form	...27
	3. Business Purpose Test	...32
	4. Sham Transactions	...35
	5. Step Transactions	...38
	C. <i>Stuart Investments Ltd. v. M.N.R.</i>	...40
Chapter Two	Political Antecedents of the General Anti-Avoidance Rule	...48
	A. Context of Enactment	...49
	1. Essence of the Tax Reform	...50
	2. Noteworthy Aspirations of the Reform	...52
	B. Paving the Way	...56

	C. Alternatives to the General Anti-Avoidance Rule	...63
	1. Statutory Limitations of Tax Avoidance	...64
	2. Judicial Limitations of Tax Avoidance	...67
	3. Experience of Others	...68
	a) Civil Law Jurisdictions	...68
	b) United Kingdom	...71
	c) United States of America	...75
	d) Australia and New Zealand	...78
	D. GAAR: the Outcome	...79
Chapter Three	Doctrinal Law related to the General Anti-Avoidance Rule	...87
	A. Doctrinal Law developed under the General Anti-Avoidance Rule	...88
	1. Documents generated under GAAR	...88
	2. GAAR in the <i>Income Tax Act</i>	...107
	3. GAAR's Influence on Tax Planning Practices	...114
	B. Doctrinal Law developed after the General Anti-Avoidance Rule	...118
Chapter Four	Reflections on the General Anti-Avoidance Rule	...134
	A. Effectiveness of the General Anti-Avoidance Rule	...134
	1. Amending GAAR	...135
	2. Adjusting the Minister's Approach to GAAR	...139
	3. Adjusting the Courts' Approach to GAAR	...142
	4. Providing the Courts with Interpretive Tools	...144
	B. Effect of the General Anti-Avoidance Rule on Tax Avoidance	...148
CONCLUSION		...152
Table of Cases		...154
Bibliography		...159
Appendix One	Text of the General Anti-Avoidance Rule	...164

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## INTRODUCTION

Where lies a rule also lies temptation to circumvent it. The foregoing principle reaches as far back in time as Adam and Eve. Tax rules are no exception to this principle: tax avoidance is extremely tempting, particularly, since successful tax avoidance is accompanied by financial reward. Suggestions to alleviate one's share of the tax burden are welcomed by most people and, as a result, there has been an on-going conflict between Revenue Canada trying to enforce compliance with the Canadian taxation system and the taxpayers to avoid taxes. In an attempt to circumscribe tax avoidance, the Department of Finance, as part of the Tax Reform of 1987, conceived and enacted a general anti-avoidance rule.<sup>1</sup>

The effect of GAAR on tax planning, however, is to clothe it with uncertainty. To date, Revenue Canada's auditors have made very little use of their new weapon in litigation under the *Act*,<sup>2</sup> but one can not deny its existence. Accordingly, this thesis will address this uncertainty and speculate as to the future of GAAR. Its purposes are threefold:

- (a) to lift the veil on the antecedents of the general anti-avoidance rule;
- (b) to clarify some of the uncertainty generated by GAAR and to hypothesize as to its future interpretation; and
- (c) to discuss the impact of GAAR on tax avoidance.

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<sup>1</sup> *Income Tax Act*, R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63, and as subsequently amended [hereinafter referred to as the "*Act*"], section 245. Section 245 of the *Act* is best known by its acronym "GAAR" which stands for General Anti-Avoidance Rule [hereinafter referred to as "GAAR"].

<sup>2</sup> As of December 31, 1994, Revenue Canada had referred 102 cases to the GAAR committee (the GAAR committee has been set up by Revenue Canada to supervise the application of GAAR to tax avoidance cases). Of those 102 cases, only 14 found their way into court, the decisions of which are still pending. See: Claude Desy, ed., *The Access Letter*, vol.5, no.10 (Montreal: Dacfo, Looseleaf).

See also: *Michelin Tires Ltd. v. M.N.R.*, [1995] C.I.T.T. No. 20, Appeal No. AP-93-333, which is a decision rendered by the Canadian International Trade Tribunal on March 22, 1995, and which ruled on section 274 of the *Excise Tax Act*, R.S., c. E-12. Section 274 is very similar to section 245 of the *Act*.

These purposes will be addressed through an analysis of:

- (a) the Legal Antecedents of the General Anti-Avoidance Rule;
- (b) the Political Antecedents of the General Anti-Avoidance Rule;
- (c) the Doctrinal Law related to the General Anti-Avoidance Rule; and
- (d) some Reflections on the General Anti-Avoidance Rule.

Underlying these purposes is the question of whether or not GAAR has changed the face of tax avoidance.

Chapter One reviews the *pre*-GAAR case law pertaining to former subsection 245(1) of the *Act* and to the judicial doctrines of ineffective transactions, substance over form, business purpose test, sham transactions and step transactions. Special attention is also paid to *Stuart Investment Ltd. v. M.N.R.*<sup>3</sup> which played a pivotal role in the enactment of GAAR. This review of the legal precursors to GAAR demonstrates that anti-avoidance weapons prior to GAAR, because of their limited and inconsistent articulation in the Canadian tax context, offered very little support to Revenue Canada to challenge tax avoidance schemes.

In particular, it is demonstrated that former subsection 245(1) had inherent substantive and remedial limitations. Moreover, its inconsistent application by the courts rendered the provision an unreliable tool for Revenue Canada to shut down certain tax avoidance schemes. Far from offering any more support to Revenue Canada, the judicial anti-avoidance doctrines applied differently in similar situations because no consensus was reached on their proper

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<sup>3</sup> [1984] 1 S.C.R. 536, [1984] C.T.C. 294, 84 D.T.C. 6305.

definition. It was also apparent that the courts' general tendency in applying either former subsection 245(1) or any one of the judicial doctrines was to favour the taxpayers.<sup>4</sup>

Chapter Two examines the policy considerations that led to the enactment of GAAR. Since GAAR was part of the Tax Reform of 1987, the underlying objectives of that reform process influenced some of the policy considerations of GAAR. Among those are the objectives of fairness, competitiveness and reliability. In pursuance of these objectives, the Department of Finance acknowledged that it had to overcome the existence of rampant tax avoidance in the taxation system. Tax avoidance in the system was the combined product of a flourishing tax expenditure program and social behaviour, and was unconstrained because there were no appropriate tools to deal with it. The interrelations of all these considerations and how together they commanded a prompt reaction from the Department of Finance is also examined.

Chapter Two weighs the various responses to tax avoidance which were available to the Department, and their governing principles. It seeks wisdom in the experiences of the Civil Law jurisdictions, the United Kingdom, the United States and, Australia and New Zealand. The examination of these policy considerations is complemented by a brief analysis of the outcome of the legislative process and provides some responses to the most legitimate criticisms of GAAR, thereby asserting the need for, and the basic legitimacy of, such an encompassing rule to deal with tax avoidance.

Chapter Three comments on the doctrinal law developed both *pre* and *post* GAAR. As there has been to date no judicial interpretation of GAAR, I shall infer its interpretation from

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<sup>4</sup> See e.g.: *Stuart Investments Ltd. v. M.N.R.*, *ibid.*; *Consolidated-Bathurst Ltd. v. M.N.R.*, [1985] 1 C.T.C. 142, 85 D.T.C. 5120 (F.C.T.D.); *Produits L.D.G. Products Inc. v. M.N.R.*, [1976] C.T.C. 591, 76 D.T.C. 6344 (F.C.A.); *M.N.R. v. Alberta and Southern Gas Co.*, [1978] 1 F.C.R. 454, 77 D.T.C. 5244 (F.C.A.); *Edmonton Liquid Gas Limited v. M.N.R.*, [1984] C.T.C. 536, 84 D.T.C. 6526 (F.C.A.); *Irving Oil Ltd. v. M.N.R.*, [1988] 1 C.T.C. 263, 88 D.T.C. 6138 (F.C.T.D.); *Massey-Ferguson Ltd. v. M.N.R.*, [1977] C.T.C. 6, 77 D.T.C. 5013 (F.C.A.); *Indalex Ltd. v. M.N.R.*, [1986] 2 C.T.C. 482, 86 D.T.C. 6039 (F.C.T.D.).

its legislative text, the technical notes,<sup>5</sup> and Information Circular 88-2<sup>6</sup> and its supplement.<sup>7</sup> GAAR's interplay with the other provisions of the *Act* should be governed by mere logic. Nonetheless, a study of the Information Circular and supplement reveals that the Department of Finance may adopt, rightly or wrongly, a more paternalistic approach than logic would lead to. Despite the lack of case law interpreting GAAR, I shall demonstrate that GAAR has a definite deterrent effect on tax planning practices.

Through a review of the doctrinal law developed after GAAR, I shall also demonstrate that the courts are not committed to limiting tax avoidance schemes. Accordingly, it is suggested that GAAR's charging provision will likely be given a narrow interpretation, and that the exceptions to GAAR's charging provision will presumably be given a wide one.

Chapter Four consists of reflections on the rule and its implications in Canadian taxation law, which draws upon the analysis of the previous chapters. It also embodies reflections on the effects of GAAR on tax avoidance in general.

The reflections upon GAAR addresses the issues of what amendments to the rule, and changes in both the Department of Finance and the courts' attitude towards it, are needed to maximize its effectiveness. I shall demonstrate that, although GAAR could be improved, it has a tremendous potential to regulate tax avoidance. This potential, however, is subject to the courts' good will. In this regard, it is suggested that, in order to carry out the full potential of GAAR, there is a need for the endorsement by the courts of new interpretive tools in tax cases,

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<sup>5</sup> Canada, Department of Finance, *Technical Notes to Bill C-139 (Royal Assent, September 13, 1988)* (Don Mills, Ontario: CCH, 1989).

<sup>6</sup> *Information Circular 88-2, General Anti-Avoidance Rule Section 245 of the Income Tax Act*, dated October 21, 1988.

<sup>7</sup> *Information Circular 88-2, Supplement 1, General Anti-Avoidance Rule*, dated July 13, 1990.



or, at the very least, in GAAR cases, and for consistency in their approach to tax avoidance transactions.

Finally, the effects of GAAR on tax avoidance are to be examined. Since tax avoidance is not a problem strictly confined to the legal sphere, but is also largely rooted in social behaviour, the inevitable conclusion of this examination is that GAAR, as legally effective as it could be, can only have minimal effects on tax avoidance. This is so because Canadian judges, being the product of our society, will not give GAAR the broad interpretation the Department of Finance designed it to have. Accordingly, it is suggested that, because GAAR will not receive a liberal interpretation, and because the Department of Finance cannot change social behaviour, the Department of Finance should perhaps envisage to tackle the problem of tax avoidance by addressing its other cause, and re-think the validity of tax expenditures.

From a taxpayer's perspective, GAAR<sup>1</sup> is the most encompassing, sweeping and potentially most damaging anti-avoidance measure this country has ever seen. To this extent, its introduction in the Canadian taxation system can be seen as revolutionary. However, to the extent that GAAR is perceived as just another attempt by the Minister of Finance to deal with tax avoidance, it in no way qualifies as revolutionary.

Anti-avoidance measures were present in the Canadian taxation system long before GAAR came into force in 1988. These measures were of an administrative, legislative and judicial nature. For our purposes, the measures under scrutiny are limited to those of a legislative and judicial nature. At the legislative level, the government "garnished" the *Act* with a number of anti-avoidance provisions of varying specificity;<sup>2</sup> and, at the judicial level, the courts developed several anti-avoidance doctrines. The combined application of both types of measures gave rise to an interesting yet unreliable body of jurisprudence from which GAAR's legal antecedents can be derived.

The study of those legislative measures is limited to a review of the scope of former subsection 245(1) of the *Act*, since it is GAAR's direct ancestor. With respect to the judicial measures, the discussion focuses on the anti-avoidance doctrines elaborated through judges' decisions. A review of *Stuart Investments Ltd. v. M.N.R.*,<sup>3</sup> a decision of the Supreme Court

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<sup>1</sup> *Income Tax Act*, R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63, and as subsequently amended, section 245.

<sup>2</sup> *Income Tax Act*, *ibid.*, section 67 and subsections 55(1), 245(1) and 245(1.1) are examples of more general, anti-avoidance provisions, as opposed to sections and subsections 95(6), 187.1, 87(4) and 110.6(8) which are very specific in nature.

<sup>3</sup> [1984] 1 S.C.R. 536, [1984] C.T.C. 294, 84 D.T.C. 6305 [hereinafter referred to as *Stuart* cited to D.T.C.].

of Canada, follows this discussion. Because of its importance, both in the development of the doctrines and as a rationale for GAAR, *Stuart's* review appears under a separate heading.

#### A. Former Subsection 245(1) of the *Income Tax Act*

The origins of former subsection 245(1) can be traced to subsection 6(2) of the *Income War Tax Act*.<sup>4</sup> On September 13, 1988, however, former section 245 of the *Act* was repealed. The repeal of former subsection 245(1), as the repeal and amendment of other provisions,<sup>5</sup> was a direct a consequence of GAAR's enactment.

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<sup>4</sup> S.C. 1917, c.28, as amended.

For a discussion of the origins of former subsection 245(1), see: Brian J. Arnold & James R. Wilson, "The General Anti-Avoidance Rule - Part I", (1988) 36 Can. Tax J. 829-887, at 842; Vern Krishna, *Tax Avoidance: The General Anti-Avoidance Rule* (Toronto: Carswell, 1990) at 24.

Subsection 6(2), titled "Limitation of Expenses", was added to the *Income War Tax Act* in 1933. It saved the Minister the authority to disallow the deduction of certain expenses. It was added by S.C. 1932-33, c.41, section 7, which provided:

(2) The Minister may disallow as an expense the whole or any portion of any salary, bonus, commission or director's fee which in his opinion is in excess of what is reasonable for the services performed.

In 1940, subsection 6(2) was amended to extend the Minister's authority to two particular sets of circumstances. It was introduced by S.C. 1940, c.34, section 17, which provided:

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

Further amendments to the *Income War Tax Act*, in 1948, seem to have drawn a distinction between the two parts of subsection 6(2). Its first part was moved to Part I of the *Act* to become section 67. Its second part was moved to Part V of the *Act* in subsection 125(1), "Artificial Transaction". Part V was then labelled "Tax Evasion" and, since May 23, 1985, has been labelled "Tax Avoidance". Subsection 125(1) later became subsection 137(1) and finally subsection 245(1).

<sup>5</sup> See e.g.: *Income Tax Act*, *supra* note 1, sections 246, 247 and subsection 55(1).

Former subsection 245(1) prevented the deduction of a disbursement or expense if such deduction resulted in an undue or artificial reduction of the income:

**245(1) Artificial Transactions.** -- In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income.

The word "that" in the subsection refers to the word "deduction", not "transaction" or "operation".<sup>6</sup> Accordingly, and for the sake of clarity, subsection 245(1) should be construed as follows:

In computing income for the purpose of this Act no deduction that if allowed would unduly or artificially reduce the income may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation.<sup>7</sup>

Former subsection 245(1) can be conceptualized as a legislative safety net designed to catch taxpayers who try to get away with "deductions of an unforeseeable nature".<sup>8</sup>

Advocates of GAAR contend that, despite the position of the Supreme Court in *Stubart*,<sup>9</sup> former subsection 245(1) was not a general anti-avoidance rule and contained inherent limitations. As Brian Arnold commented, "[e]ven on a superficial examination, it [former subsection 245(1)] does not apply to deductions in computing taxable income, deductions in

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<sup>6</sup> *Shulman v. M.N.R.*, [1961] C.T.C. 385, 61 D.T.C. 1213 (Ex.Ct.) [hereinafter referred to as *Shulman* cited to D.T.C.] at 1221.

<sup>7</sup> *Ibid.*

<sup>8</sup> *Stikeman, Canada Tax Service*, vol.11 (Don Mills, Ontario: Richard De Boo, Looseleaf Services) at 245-127:

Former subsection 245(1) was a loophole-closing provision designed to forestall deductions of an unforeseeable nature not specifically legislated against elsewhere in the Act which had their origins in schemes dictated less by business expediency than by the hope of minimizing or escaping tax.

<sup>9</sup> *Infra* note 109 and accompanying text.

computing tax payable, or transactions that artificially reduce income but do not involve deductions."<sup>10</sup>

At no time have the courts actually paused either to consider whether former subsection 245(1) applies to deductions in computing taxable income, or to define extensively and inclusively each of its elements, with the exception of the terms "unduly" and "artificially" which have received more judicial attention. The case law that has developed under former subsection 245(1), however, can help define some of the elements of that subsection and measure the accuracy of Brian Arnold's statement. It will be demonstrated that, although it remains true that former subsection 245(1)'s scope was limited, Brian Arnold's contention understates it.

#### 1. Meaning of the Word "Deduction"

The word "deduction" is not defined in the *Act*. According to the rule of literal interpretation, unless a word has been given a particular definition in the statute in which it appears, it should be assigned its ordinary meaning.<sup>11</sup> The definition of the word "deduction" is not self-limiting.<sup>12</sup> It is "an amount deducted", "subtracted", "taken away", ...; it can be any amount or portion thereof. Brian Arnold suggests that the wording and structure of former

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<sup>10</sup> Brian J. Arnold, "In Praise of the Business Purpose Test", *Report of Proceedings of the Thirty-Ninth Tax Conference* (1987 Conference Report), Toronto, C.T.F., 1988, 10:1-34, at 10:2. See also: Krishna, V., *supra* note 4 at 25.

<sup>11</sup> *Camden v. I.R.C.*, [1914] 1 K.B. 641. See also: Elmer A. Driedger, *Construction of Statutes*, 2nd ed. (Toronto: Butterworths, 1983).

<sup>12</sup> R. E. Allen, ed., *The Concise Oxford Dictionary of current English*, 8th ed. (New York: Oxford University Press, 1990) at 302:

**deduct** ... *v.tr.* (often foll. by *from*) subtract, take away, withhold (an amount, portion, etc.) ...

**deduction** ... *n.* 1 a the act of deducting. b an amount deducted. ...

subsection 245(1) limits the scope of the word "deduction", and that consequently, deductions in computing income are the sole deductions within the subsection's ambit.<sup>13</sup> This is not, however, how it has been judicially construed.

*M.N.R. v. Antoine Guertin Ltée*<sup>14</sup> clearly refutes Brian Arnold's contention. Its subtlety lies in the fact that it dismisses a subsection 245(1) argument because the deductions did not unduly or artificially reduce the income, not because the deductions were deductions in computing taxable income, and as such, not subject to the application of subsection 245(1).<sup>15</sup> In this context, one should also consider Stone J.'s comment in *Consolidated-Bathurst Ltd. v. M.N.R.*:

In considering the application of section 137(1) to any deduction from income, however, regard must be had to the nature of the transaction in respect of which the deduction has been made. Any artificiality arising in the course of a transaction may taint an expenditure relating to it and preclude the expenditure from being deductible in computing taxable income.<sup>16</sup> [emphasis added]

Could it be more unambiguous?

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<sup>13</sup> Arnold, B.J., *supra* note 10 and accompanying text.

<sup>14</sup> [1988] 1 C.T.C. 360, 87 D.T.C. 5458 (F.C.A.) [hereinafter referred to as *Antoine Guertin* cited to D.T.C.].

During the taxation year in question, the plaintiff, Antoine Guertin Ltée, forwarded a cheque to a charitable foundation which had been incorporated by the same person who incorporated the plaintiff. It also paid out bonuses to each of its employees who agreed to forward a portion thereof to the same charitable foundation. The foundation then loaned back to the plaintiff such amount totalling the accumulated charitable gifts at a profitable rate of interest. It later distributed its revenues from interest to other charitable organizations. The Minister attacked the deductibility of the donations on two grounds: sham transactions doctrine and former subsection 245(1). The court dismissed both arguments.

<sup>15</sup> Compare: *supra* notes 10 and 13, and accompanying text.

<sup>16</sup> [1987] 1 C.T.C. 55, 87 D.T.C. 5001 (F.C.A.) [hereinafter referred to as *Consolidated-Bathurst*, cited to D.T.C.] at 5004.

The courts have also applied former subsection 245(1) to determine the deductibility of a claim for depreciation or capital cost allowance,<sup>17</sup> terminal loss,<sup>18</sup> insurance premiums,<sup>19</sup> foreign trade debt,<sup>20</sup> losses incurred pursuant to an "after-the-fact" declaration of trust,<sup>21</sup> and charitable gifts.<sup>22</sup> Furthermore, the payment of management and service fees, or rents, to corporations incorporated for the purpose of diverting income has received considerable attention under former subsection 245(1).<sup>23</sup>

*Alberta and Southern Gas* also refutes the assumption that former subsection 245(1) strictly applies to deductions in computing income. According to Pratte C. J., one must first determine whether money has been paid out for the purpose of earning a profit. Secondly, one must determine whether the *Act* makes other amounts -- expenses or not -- deductible.<sup>24</sup> He

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<sup>17</sup> *M.N.R. v. Alberta and Southern Gas Co.*, [1978] 1 F.C.R. 454, 77 D.T.C. 5244 (F.C.A.) [hereinafter referred to as *Alberta and Southern Gas* cited to D.T.C.]; *M.N.R. v. Gelber*, [1983] C.T.C. 381, 83 D.T.C. 5395 (F.C.A.). In the latter case, the Crown was unsuccessful, but the court nevertheless secured its decision on the basis of former subsection 245(1).

<sup>18</sup> *Stephen Construction Co. v. M.N.R.*, [1970] Tax A.B.C. 801.

<sup>19</sup> *Consolidated-Bathurst Ltd. v. M.N.R.*, [1985] 1 C.T.C. 142, 85 D.T.C. 5120 (F.C.T.D.) [hereinafter referred to as *Consolidated-Bathurst*, *FCTD*, cited to D.T.C.].

<sup>20</sup> *D.W.S. Corporation v. M.N.R.*, [1968] C.T.C. 65, 68 D.T.C. 5054 (Ex.Ct.).

<sup>21</sup> *Pasadena Development Corp. v. M.N.R.*, [1968] Tax A.B.C. 567.

<sup>22</sup> *Antoine Guertin*, *supra* note 14; *Placements L.T.G. Inc. et al. v. M.N.R.*, [1980] C.T.C. 2714, 80 D.T.C. 1637 (T.R.B.).

<sup>23</sup> *Shulman*, *supra* note 6; *Murphy v. M.N.R.*, [1968] C.T.C. 248, 68 D.T.C. 5178 (Ex.Ct.); *Grotell v. M.N.R.*, [1972] C.T.C. 480, 72 D.T.C. 6409 (F.C.T.D.); *J & J Hotels Ltd. v. M.N.R.*, [1974] C.T.C. 670, 74 D.T.C. 6505 (F.C.A.); *Mendels v. M.N.R.*, [1978] C.T.C. 404, 78 D.T.C. 6267 (F.C.T.D.) [hereinafter referred to as *Mendels* cited to D.T.C.].

<sup>24</sup> *Alberta and Southern Gas*, *supra* note 17 at 5247, 5248:

Other amounts are, however, specially made deductible by statute, for example,

(a) amounts on account of capital ...

(b) amounts that are deductible under statutory rules made for unusual situations in an attempt to obtain a result as equitable as possible having regard to the abnormal results obtained by applying the ordinary rules ...

(c) amounts that were not laid out for the earning of profit ... but the deduction of which is allowed by Parliament to achieve some end that Parliament wishes to encourage.

concludes that "considering it in its context in the scheme of the Act, section 245(1) is applicable to every class of deductible expenses."<sup>25</sup>

2.     Meaning of the Phrase "Disbursement or Expense made or incurred in respect of a Transaction or Operation"

The phrase "disbursement or expense made or incurred in respect of a transaction or operation" has not, as a phrase, received judicial attention and has not been judicially defined. Judicial attention, albeit little, has been given to its four components: "disbursement", "expense", "transaction" and "operation".

a)     "Disbursement" or "Expense"

As early as 1947, the Privy Council in *M.N.R. v. Wrights' Canadian Ropes Ltd.*<sup>26</sup> had the opportunity to discuss the meaning of the word "expense" in subsection 6(2) of the *Income War Tax Act*.<sup>27</sup> In that case, Wrights' Canadian Ropes Ltd. ("Canadian Ropes") paid different amounts to an English company. The amounts were paid according to a contract entered into by both Canadian Ropes and the English company. The Minister disallowed the deduction of such amounts on the basis that they were not "expenses" within the meaning of subsection 6(2), "since they were payments made under a valid contract as consideration for the contractual

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<sup>25</sup> *Ibid.* at 5248.

<sup>26</sup> [1947] A.C. 109 (P.C.) [hereinafter referred to as *Wright's Canadian Ropes*].

<sup>27</sup> *Supra* note 4.



benefits thereby conferred."<sup>28</sup> The court disagreed with the Minister's argument as "[i]t appears to them [their Lordships] that the word 'expense' as used in the sub-section has a quite general meaning and is wide enough to cover any expenditure by the taxpayer whether made under or as a condition of obtaining a contract or otherwise."<sup>29</sup>

Two more recent cases, *M.N.R. v. Esskay Farms* and *M.N.R. v. McKee*, define the words "disbursement" or "expense".

... The word "disbursement" in common parlance means "money paid out, an expenditure" and the word "expense" also in common parlance means "money out of pocket". I see no valid reason for ascribing any other meaning to those words as used in the context of section 137(1).<sup>30</sup>

I have searched several dictionaries ... It seems abundantly clear that the common ordinary sense of the word "expense" pertains to a payment, an outlay of money and expenditure or that which has created a liability or which might have necessitated the transfer of some assets in payment therefor. It can also mean the cost of a thing or whatever must be given up or surrendered for it. The word "disbursement" is even more indicative of an immediate outlay or payment and signifies an expenditure.<sup>31</sup>

In *Esskay Farms*, Cattanach J. denied the benefit of subsection 137(1) to the Minister. In order to benefit from section 85B(1)(d)'s reserve, now 20(1)(n), *Esskay Farms Ltd.*, a dealer in real estate, interposed a trust company between itself and the purchaser, in the sale of some property. The Minister disallowed the deduction on the basis that the taxpayer had artificially reduced its income. Because the taxpayer received money, the court's opinion was that the

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<sup>28</sup> *Wrights' Canadian Ropes*, *supra* note 26 at 117.

<sup>29</sup> *Ibid.*

<sup>30</sup> *M.N.R. v. Esskay Farms Ltd.*, [1976] C.T.C. 24, 76 D.T.C. 6010 (F.C.T.D.) [hereinafter referred to as *Esskay Farms* cited to D.T.C.] at 6017.

<sup>31</sup> *McKee v. M.N.R.*, [1977] C.T.C. 491, 77 D.T.C. 5545 (F.C.T.D.) [hereinafter referred to as *McKee* cited to D.T.C.] at 5347.

transaction involved neither a disbursement nor an expense within the meaning of subsection 137(1) and therefore it did not apply.

Addy J., in *McKee*, relied on his definitions of the words "disbursement" and "expense" to uphold the Minister's reassessment which disallowed a deduction for capital cost allowance. Addy J. overruled an *obiter dictum* from the Supreme Court of Canada in *M.N.R. v. Harris*<sup>32</sup> in which the Supreme Court recognized the applicability of subsection 137(1) to claims for capital cost allowance: "... the words 'capital cost allowance' themselves describe an allowance to compensate for the cost or expense. Surely, this allowance itself cannot be the cost, expense or expenditure for which it is intended to provide some tax relief"<sup>33</sup> [emphasis in original].

Both the Federal Court -- Trial Division, in *McKee*, and the Supreme Court of Canada, in *Harris*, rely on the wrong premise; they wrongfully equate a claim for capital cost allowance with "disbursement" or "expense". Moreover, the Supreme Court of Canada shows some discrepancy in its reasoning. As opposed to the Federal Court which, from a wrong premise, logically arrives at the wrong conclusion, the Supreme Court goes illogically from a wrong premise to the right conclusion that subsection 137(1) applies to a claim for capital cost allowance. A claim for capital cost allowance is a deduction, not an expense. When considering a claim for capital cost allowance, the "disbursement" or "expense" is the amount expended for the acquisition of capital property or portion thereof. The claim for capital cost allowance itself is a deduction which the taxpayer is entitled to as a result of statutory rules. Because it is a deduction, such a claim is subject to the application of former subsection 245(1).

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<sup>32</sup> [1966] S.C.R. 489, 66 D.T.C. 5189 (S.C.C.) [hereinafter referred to as *Harris* cited to D.T.C.] at 5198: The words in the sub-section "a disbursement or expense made or incurred" are, in my opinion, apt to include a claim for depreciation or for capital cost allowance, ...

<sup>33</sup> *McKee*, *supra* note 31 at 5347.

A "disbursement" or "expense" and its correlated "deduction" are analogous to an "action" and its correlated "consequence". The taxpayer's action consists of expending money, hoping to make a profit. By virtue of the *Act*, the taxpayer is empowered to account for that expenditure by deducting it from his or her income. Only the *Act* makes a deduction consequential to a disbursement; the legislator could decide otherwise. Ignorance of this fact leads to confusion and conclusions such as in *McKee*.

b) "Transaction" or "Operation"

The definitions of the above two words result from a single case, *Mendels*<sup>34</sup>:

The words "transaction" and "operation" appear in the section. In the context the word "operation" contemplates a continuity whereas by the juxtaposition of the word "transaction" to the word "operation" must contemplate one or more individual transactions and may lack the necessity of prolonged continuity.<sup>35</sup>

There also exists a close relation between the words "transaction", "operation" and the word "deduction" inasmuch, as artificiality is concerned. The artificiality of a transaction or operation "may taint"<sup>36</sup> a related deduction and prevent it from being deductible.<sup>37</sup>

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<sup>34</sup> *Supra* note 23.

<sup>35</sup> *Ibid.* at 6272.

<sup>36</sup> *Consolidated-Bathurst*, *supra* note 16 at 5004.

<sup>37</sup> *Ibid.*; *Shulman*, *supra* note 6; *Sigma Explorations Ltd. v. M.N.R.*, [1975] C.T.C. 215, 75 D.T.C. 5121 (F.C.T.D.) [hereinafter referred to as *Sigma Explorations* cited to D.T.C.].

Certainly, in the course of a transaction or operation, one or more disbursements or expenses may be incurred for which deductions will be sought. Since a transaction can only be artificial insofar as all or some of its elements are artificial, it is likely that all or some of the disbursements made in respect of an artificial transaction would be artificial and so would their deduction.

### 3. Meaning of the Words "Unduly" or "Artificial"

The concept of undue and artificial reduction of income has generated a great body of case law. "Unduly" has been understood to refer to the notion of quantum, and "artificially", to the norm:

I interpret "unduly" as relating to quantum and meaning "excessively" or "unreasonably". In the context found here, "artificially" means "unnatural" -- "opposed to natural" or "not in accordance with normality".<sup>38</sup>

The concept of undue or artificial reduction of income is comprised of two notions: sham transactions and something of lesser seriousness referred to as artificial transactions.<sup>39</sup> Accordingly, former "subsection 245(1) is directed not only to sham transactions but to something less as well where the expense, although real, would unduly or artificially reduce a

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<sup>38</sup> *Shulman, ibid.* at 6120. See also: *Mendels, supra* note 23; *Don Fell Ltd. et al. v. M.N.R.*, [1981] C.T.C. 363, 81 D.T.C. 5282 (F.C.T.D.) [hereinafter referred to as *Don Fell* cited to D.T.C.]; *Consolidated-Bathurst, FCTD, supra* note 19; *Brown v. M.N.R.*, [1985] C.T.C. 2017, 85 D.T.C. 39 (T.C.C.) [hereinafter referred to as *Brown* cited to D.T.C.]; *Bonavista Cold Storage Company v. M.N.R.*, [1983] C.T.C. 2093, 83 D.T.C. 89 (T.R.B.) [hereinafter referred to as *Bonavista Cold Storage* cited to D.T.C.].

Although both words are usually combined in the formulation of the Minister's arguments, "artificially" seems to have developed into a broader concept than its mere definition. "Unduly" has not developed that way. Perhaps it is because it does not have a corresponding noun form, but most certainly because "artificially" has a more flexible definition.

<sup>39</sup> *Don Fell, ibid.* at 5291:

This concept of an undue or artificial reduction of income includes "sham" transactions and "artificial" transactions.

Cited with approval in *Bonavista Cold Storage, ibid.* See also: *Sigma Explorations, supra* note 37.

taxpayer's income."<sup>40</sup> It has however to be more than unreasonable expenses,<sup>41</sup> and is not synonymous with fictitious.<sup>42</sup>

As a matter of general application, a court finding is based upon the evidence adduced before it. In the particular context of undue and artificial reduction of the income of a taxpayer, the evidence adduced by the taxpayer is a key element. Notwithstanding how subjective this evidence is, it has been held that a finding of artificiality should turn on an objective test:

The test in deciding whether a deduction is prohibited by ss. 137(1) must, as I see it, be an objective one. The main source of the evidence relating to it is commonly the taxpayer. The evidence is therefore often subjective in nature. An assessment of its weight and reliability is of necessity

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<sup>40</sup> *Don Fell, ibid.* at 5291. Cited with approval in *Bonavista Cold Storage, ibid.*

As the notion of sham transactions developed independently from subsection 245(1) before being brought within its sphere of application, its study is reserved until judicial doctrines on tax avoidance are examined.

<sup>41</sup> *Sigma Explorations, supra* note 37 at 5124, 5125:

... I conclude the prohibition there is directed not only at sham transactions but at something less, where the outlay, although real and apparently *bona fide*, would unduly or artificially reduce a taxpayer's income. I conclude further that the subsection is aimed at prohibiting deductions in respect of transactions more tainted than those resulting in unreasonable outlays or expenses otherwise deductible ...

<sup>42</sup> In *Spur Oil Ltd. v. M.N.R.*, [1980] C.T.C. 170, 80 D.T.C. 6105 (F.C.T.D.) [hereinafter referred to as *Spur Oil* cited to D.T.C.] at 6119, Gibson J. reiterated the distinction made in *Seramko v. I.T.C.* (1976), S.T.C. 100, between artificial and fictitious: "[a] fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. 'Artificial' as descriptive of a transaction is, in their Lordships' view, of a wide import."

Gibson J. also divided artificial transactions into four categories. *Spur Oil, ibid.* at 6119, 6120:

- (i) Inherently artificial transactions such as capital cost allowance transactions, depletion allowance transactions or other specific relieving provisions ... , all of which appear to take precedent over the general anti-avoidance provision in section 137(1) of the *Canadian Income Tax Act*;
- (ii) Transactions proven by evidence to be artificial ... ;
- (iii) Some transactions that are not at arm's length. *Prima facie*, the conclusion is that such transactions are artificial;
- (iv) Some transactions that are entered into by so-called off-shore corporations where the management and control of such off-shore corporations is elsewhere than in such off-shore locations. *Prima facie*, the conclusion is that the transactions entered into by such off-shore corporations are artificial.

Despite the fact that the Federal Court of Appeal in *Spur Oil*, [1981] C.T.C. 336, 81 D.T.C. 5168 (F.C.A.), does not draw the same conclusions on the facts as Gibson J. of the Trial Division, it agrees with his interpretation of former subsection 245(1). Nonetheless, caution should be the rule since

- (a) the Court of Appeal did not expressly endorse it, although it did not deny it either;
- (b) it has not become an authoritative statement which others look up to; and
- (c) all is not black and white when it comes down to a finding of artificiality.

required, but in the final analysis the overall finding of undueness or artificiality (or not) is a value judgment based on all the facts and factors.<sup>43</sup>

This theory that "the overall finding ... is a value judgment based on all the facts and factors" has given rise to business purpose and "object and spirit" considerations. Though the theory has never been rejected and has even been widely accepted, it is interesting to note the variations in the weight conferred to the taxpayer's intention from one case to another.

Some cases have held that if the primary purpose of a transaction is not to reduce the income, then the reduction cannot be artificial.<sup>44</sup> Those cases are contradicted in *Consolidated-Bathurst, FCTD*,<sup>45</sup> by Strayer J. who states: "I do not understand this [Estey J.'s comments in *Stubart*<sup>46</sup> that a lack of business purpose may make section 137 applicable] to mean, however, that the presence of a *bona fide* business purpose necessarily makes section 137 or its successor inapplicable. That is, the absence of a *bona fide* business purpose is not a condition precedent to the application of subsection 245(1) if artificiality is otherwise established ..."<sup>47</sup>

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<sup>43</sup> *Sigma Explorations*, *supra* note 37 at 5125. Cited with approval in *Don Fell*, *supra* note 38. See also: *Consolidated-Bathurst, FCTD*, *supra* note 19.

<sup>44</sup> *Antoine Guertin Ltée v. M.N.R.*, [1981] C.T.C. 351, 81 D.T.C. 5045, at 5049:

... ces dons ne m'apparaissent pas comme ayant été effectués dans le but primordial de diminuer le revenu, même si ce résultat a été obtenu ... Cette réduction du revenu n'est donc pas nécessairement irréaliste et artificielle.

*Brown*, *supra* note 38 at 41:

There was nothing in evidence to show that the Appellant acted except for business reasons. He said this in evidence and his dealing were at arm's length. Mr. Brown also stated that he did realize there could be tax advantages to his dealings

<sup>45</sup> *Supra* note 19.

<sup>46</sup> *Supra* note 3.

<sup>47</sup> *Consolidated-Bathurst, FCTD*, *supra* note 19 at 5124.

Some other cases have held that the intention of the taxpayer is irrelevant.<sup>48</sup> In addition, in specific instances where the statutory provisions create tax incentives for the taxpayers, his or her purpose is rendered irrelevant by the very nature of the provision.<sup>49</sup>

Still, other cases have held that, in order to avoid a finding of artificiality, the requirement of a *bona fide* business purpose test is compelling.<sup>50</sup>

Despite the presence of good will, these judgments have not reached a definitive unifying principle. The odds are probably set with a panoply of unspoken factors such as the judges' personality, his or her ideology, his or her political leaning, the quality of the arguments submitted by counsel, the familiarity of the factual settings of the case and the overall economic impact of the decision, more than with the *stare decisis* principle.

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<sup>48</sup> *Ibid.* See also: *Produits L.D.G. Products Inc. v. M.N.R.*, [1976] C.T.C. 591, 76 D.T.C. 6344 (F.C.A.) [hereinafter referred to as *Produits L.D.G.* cited to D.T.C.] at 6349:

Assuming that appellant acted from the motives imputed to it in the judgment *a quo* [which motives were that the transaction had been entered solely to secure tax benefits] ... it would not follow, in my opinion, that s. 137(1) should apply here. There is nothing reprehensible in seeking to take advantage of a benefit allowed by the law. If a taxpayer has made an expenditure which, according to the Act, he may deduct when calculating his income, I do not see how the reason which prompted him to act can in itself make this expenditure non-deductible.

<sup>49</sup> *Alberta and Southern Gas*, *supra* note 17 at 5249:

That being what the provisions seem to have been intended to encourage, as it seems to me, a transaction that clearly falls within the object and spirit of [such provisions] cannot be said to unduly or artificially reduce income merely because the taxpayer was influenced in deciding to enter into it by tax considerations.

Cited with approval in *Edmonton Liquid Gas Limited v. M.N.R.*, [1984] C.T.C. 536, 84 D.T.C. 6526 (F.C.A.) [hereinafter referred to as *Edmonton Liquid Gas* cited to D.T.C.].

<sup>50</sup> *Mendels*, *supra* note 23 at 6272:

... the question with respect to that transaction is whether that transaction is one which "artificially" reduces the plaintiff's income.

In the consideration of this question it is of paramount importance to consider what *bona fide* business purpose is sought to be achieved and if any such purpose was achieved.

#### 4. Assessment of the Effectiveness of Former Subsection 245(1)

We have seen that, besides confusing a claim for capital cost allowance with a disbursement, the courts gave a broad meaning to the word "deduction" which, by itself, did not limit the scope of former subsection 245(1). Its conjunction with the word "income", however, restricted the application of the former subsection to the computation of income and taxable income. Any deductions in computing the amount of tax payable would not be subject to the provision. Moreover, with the conversion of tax deductions into tax credits, the word "deduction" would most certainly have become a more limiting notion.

For former subsection 245(1) to apply, the requirement that a disbursement or expense be made or incurred undoubtedly has diminished the Minister's liberty to have recourse to it; tax deductions relating to a reserve usually fall within that category. *Esskay Farms*<sup>51</sup> illustrates this shortfall. Tax planning around reserves for bad debts and capital gains would also have presented problems for the Minister.

The one case dealing directly with the meaning of the words "transaction" or "operation", *Mendels*,<sup>52</sup> has not caused any headaches for the Minister because it gives these words all the flexibility they can bear.

With respect to the aspect of undue and artificial reduction of income, I believe that the courts, in early cases, were overly generous to the Minister.<sup>53</sup> Once it is established that "unduly" means "excessively" and that "artificially" means "not in accordance with normality", a strict construction of former subsection 245(1) bases a decision either upon numbers or norm,

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<sup>51</sup> *Supra* note 30.

<sup>52</sup> *Supra* note 23.

<sup>53</sup> *Ibid.* and *supra* note 50, and accompanying text.



regardless of the taxpayer's intention. Towards the late 1970's and early 1980's, however, the tendency has been to adopt a stricter interpretation of subsection 245(1). In this regard, *Stubart and Irving Oil Ltd. v. M.N.R.*<sup>54</sup> should be noted. These cases and others<sup>55</sup> regard the taxpayer's intention as being irrelevant to a finding of artificiality. As far as this general principle is concerned, I agree with the court's approach to former subsection 245(1). It is in its application that the writer finds problems. The courts have applied this principle in such a way that former subsection 245(1) has become almost useless to monitor tax avoidance.

The remedy available under former subsection 245(1) is limited to the disallowance of the deduction which unduly or artificially reduces the income. The Minister cannot, for income tax purposes, ignore or recharacterize a transaction; he cannot readjust the tax assessment of third parties; he is even unable to disallow only a portion of the deduction as he formerly could under subsection 6(2) of the *Income War Tax Act*.<sup>56</sup>

In conclusion, strictly from a legislative perspective, if the Minister of Finance wished to exercise a significant control over tax avoidance, former subsection 245(1) was for the foregoing reasons insufficient.

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<sup>54</sup> *Stubart, supra* note 3; *Irving Oil Ltd. v. M.N.R.*, [1988] 1 C.T.C. 263, 88 D.T.C. 6138 (F.C.T.D.) [hereinafter referred to as *Irving Oil* cited to D.T.C.]. In *Irving Oil, ibid.* at 300, having concluded that subsection 137(1) does not apply, the Federal Court makes it clear that it will not be creative to assist the Minister of Finance:

No doubt the sum of \$141 millions with interest would be a welcome realization by the Department of National Revenue and would be seen as helping to lighten the tax burden of poor taxpayers or those of modest means; but those are strictly not the Court's concern in interpreting and applying the law regarding any particular appellant taxpayer. For some, that strict limitation of the Court's concern may be a matter of regret, but even that is not the Court's concern, for the Court does not interfere with the proper political roles of Parliament or of the executive government. Equity does not enter into tax law. Furthermore, if Parliament were ever to will that a Canadian plaintiff, as here, be taxed on its offshore subsidiary's non-canadian profits from supplying goods at fair market value, it is not beyond Parliament's constitutional competence to devise such a law.

<sup>55</sup> See e.g.: *Consolidated-Bathurst, FCTD, supra* note 19; *Produits L.D.G., supra* note 48.

<sup>56</sup> *Supra* note 4.

## B. Judicial Doctrines of Tax Avoidance

There is a seminal principle in Canadian taxation law which provides that one's tax liability should be assessed on the legal consequences, as opposed to the economic consequences of one's transactions. This perennial principle has been enunciated in many instances, but the leading case on this matter is *I.R.C. v. Westminster (Duke)*.<sup>57</sup> Lord Tomlin wrote:

The only function of a Court of law is to determine the legal result of his dispositions so far as they affect tax.<sup>58</sup>

... it is said that in revenue cases there is a doctrine that the Court may ignore the legal position and regard what is called "the substance of the matter", ... This supposed doctrine seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned, ... Every man is entitled if he can order his affairs so as to 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 unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.<sup>59</sup>

So here the substance is that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles ...<sup>60</sup>

Over the years, the courts have recognized that this approach to taxation cases had become too restrictive and as a result inappropriate to deal effectively with tax avoidance

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<sup>57</sup> [1936] A.C. 3 (H.L.) [hereinafter referred to as the *Duke of Westminster*]. See also: *Massey-Ferguson Ltd. v. M.N.R.*, [1977] C.T.C. 6, 77 D.T.C. 5013 (F.C.A.) [hereinafter referred to as *Massey-Ferguson* cited to D.T.C.].

<sup>58</sup> *Duke of Westminster*, *ibid.* at 8.

<sup>59</sup> *Ibid.* at 19, 20.

<sup>60</sup> *Ibid.* at 20, 21.

activities. Consequently, the courts have developed judicial tools to "police" such activities. These tools, or judicial doctrines, include ineffective transactions, substance over form, business purpose test, sham transactions and step transactions doctrines. Similar doctrines have developed in the United Kingdom, the United States of America, Australia and New Zealand. Their technical developments vary from one country to another, as does the importance accorded to one doctrine over another, but the similarity of their skeletons is striking. Through the use of these doctrines, the courts have not radically rejected the principle enunciated in the *Duke of Westminster* but, in certain circumstances, have adapted it.

Although the Canadian courts have favoured the ineffective transactions and sham transactions doctrines, both of which are in accordance with the *Duke of Westminster*'s principle, traces of all the others are present in Canadian taxation law. Notwithstanding their presence, one of the government's rationales for introducing GAAR into Canadian taxation law was the lack of adequate judicial limits on unacceptable tax avoidance activities.<sup>61</sup> This rationale was and probably still is subject to much controversy.<sup>62</sup>

#### 1. Ineffective Transactions

The ineffective transactions doctrine is a corollary to the principle that tax liability should be assessed on the legal results of one's transactions. The ineffective transactions doctrine challenges transactions on the basis that the intended legal results were not achieved. Under this

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<sup>61</sup> See e.g.: Canada, Department of Finance, *The White Paper on Tax Reform 1987 by the Honourable Michael H. Wilson Minister of Finance* (Ottawa: Department of Finance, on June 18, 1987) at 129.

<sup>62</sup> See e.g.: Howard J. Kellough, "Tax Reform and the Anti-Avoidance Proposals", *1987 British Columbia Tax Conference*, Toronto, C.T.F., 1988, 6:1-82.

doctrine, it is not contested that a taxpayer can arrange his or her affairs so as to attract the least amount of tax possible; the arrangements must, however, be completed and enforceable according to the relevant law:

I do not think that I should leave this appeal without expressing my views on the general question of transactions undertaken purportedly for the purpose of estate planning and tax avoidance. It is trite law to say that every taxpayer is entitled to so arrange his affairs as to minimize his tax liability. No one has ever suggested that this is contrary to public policy. It is equally true that this Court is not the watch-dog of the Minister of National Revenue. Nonetheless, it is the duty of the Court to carefully scrutinize everything that a taxpayer has done to ensure that everything which appears to have been done, in fact, has been done in accordance with applicable law. It is not sufficient to employ devices to achieve a desired result without ensuring that those devices are not simply cosmetically correct, that is correct in form, but, in fact, are in all respects legally correct, real transactions. ... I cannot accede to the suggestion, sometimes expressed, that there can be a strict or liberal view taken of a transaction, or series of transactions which it is hoped by the taxpayer will result in a minimization of tax. The only course for the Court to take is to apply the law as the Court sees it to the facts found in the particular transaction. If the transaction can withstand that scrutiny, then it will, of course, be supported. If it cannot, it will fall.<sup>63</sup> [emphasis added]

When the courts find that a taxpayer's transactions are legally incomplete, they ignore the intended legal results to give effect to the true legal results which may result in no tax benefit.

As a means of countering tax avoidance, this doctrine has done very little: a well documented and legally binding transaction, no matter how offensive it is, cannot be ignored for tax purposes. The doctrine has only one characteristic likely to offer some reassurance to the

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<sup>63</sup> *Atinco Paper Products Ltd. v. M.N.R.*, [1978] C.T.C. 566, 78 D.T.C. 6387 (F.C.A.) [hereinafter referred to as *Atinco* cited to D.T.C.] at 6395. See also: *M.N.R. v. Daly*, [1981] C.T.C. 732, 81 D.T.C. 5197 (F.C.A.) [hereinafter referred to as *Daly* cited to D.T.C.] at 5204:

In a case of this kind, where it is acknowledged that what is sought by a certain course of action is a tax advantage, it is the duty of the Court to examine *all* of the evidence relating to the transaction in order to satisfy itself that what was done resulted in a valid, completed transaction. [emphasis in original]

Minister of Finance: *Atinco* and *Daly* implicitly suggest that a transaction, for which the avowed purpose is that of tax avoidance, should be subject to greater scrutiny than if its purpose is some other purpose. Since *Stuart*, however, this characteristic has been dispensed with. Estey J. considered that, in certain circumstances, the "commercial reality" can be such that technical deficiencies are insufficient to render a transaction ineffective for tax purposes.<sup>64</sup> The requirement that the transactions be "in all respects legally correct, real transactions"<sup>65</sup> has been softened to the requirement that "commercial reality" be satisfied.

The extent to which the meaning of "commercial reality" can be stretched is not discussed in *Stuart*. Two years later however, *Indalex Ltd. v. M.N.R.*,<sup>66</sup> expands it considerably. Before discussing the conclusions reached in this case, we should note its facts:

- (a) the case involved four corporations: Indalex Ltd. ("Indalex") was the Canadian subsidiary of a Canadian corporation ("Indal") controlled by an English corporation ("RTZ") which also had a wholly owned Bermuda corporation ("Pillar");
- (b) Indalex entered into an agreement with Pillar for the purchase of aluminium billets; and
- (c) Messrs. Paterson and Fredjohn (later Mr. Greenwood) were all directors of Indal, RTZ and Pillar.

In *Indalex*, Reed J. overlooks the fact that neither the quantity of the goods to be purchased nor their price were set out in the contract between Indalex and Pillar. Reed J. concludes that the quantity could be ascertained from a letter written by Pillar to Indalex. He also concludes that

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<sup>64</sup> *Stuart*, *supra* note 3 at 6311.

<sup>65</sup> *Atinco*, *supra* note 63 at 6395.

<sup>66</sup> [1986] 2 C.T.C. 482, 86 D.T.C. 6039 (F.C.T.D.) [hereafter referred to as *Indalex* cited to D.T.C.].

the price was not uncertain since "when all was said and done, Messrs. Paterson and Fredjohn (later Mr. Greenwood) would determine that amount."<sup>67</sup> Although he agrees that "the prices paid by Indalex to 'Pillar' [as established by Messrs. Paterson and Fredjohn (later Mr. Greenwood)] were really the result of arm's length type negotiations",<sup>68</sup> the fact remains that they were not, and neither was the agreement.

The deficiencies found in *Stubart* which did not affect the commercial reality of the transaction should be contrasted with those in *Indalex*. *Stubart* involved the transfer of Stubart's business to a sister corporation, Glover. Technical deficiencies in that case were Glover's statement of its business on its annual return, licenses held by Stubart under the *Excise Act*,<sup>69</sup> and the fact that Stubart completed Glover's employees' T4-slips. *Indalex's* deficiencies were unquestionably of greater importance than *Stubart's*.

I suggest that the modifications of the ineffective transaction doctrine in *Stubart* practically called for its storage in one of Revenue Canada's cabinets. It is easy if one wants to avoid the application of the doctrine to have recourse to a good tax lawyer and, if the lawyer proves not so good after all, one can allege "commercial reality". Moreover, the introduction of a "commercial reality" argument into the ineffective transactions doctrine could lead to a reverse substance over form doctrine. Under the "usual" substance over form doctrine, the Minister of National Revenue asks the courts to look at the substance of a transaction rather than its form to sanction tax avoidance. Now, taxpayers could ask the courts to look at the commercial reality of a transaction to cover for its legal ineffectiveness and avoidance purposes.

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<sup>67</sup> *Ibid.* at 6045.

<sup>68</sup> *Ibid.* at 6043, 6044.

<sup>69</sup> R.S.C. 1952, c. 99, s. 10.

I further suggest that, should the commercial reality argument remain a part of the ineffective transactions doctrine, its merit should be judged according to an objective test independent from the particular circumstances of a case; in other words, deficiencies in the legal validity of transactions should not be saved by the commercial reality of the transactions unless they would have been saved by such reality in normal and *bona fide* arm's length transactions. On this basis, I respectfully disagree with the conclusions reached by both Divisions of the Federal Court in *Indalex*. Even if one assumes that the price negotiations "were really arm's length type negotiations", the contract between Pillar and Indalex was certainly not an arm's length type contract: who would agree to buy a car from a stranger, without knowing the price of the car, based on the premise that the price is ascertainable because "when all will be said and done, the stranger will determine that amount?" Likewise, the Indalex-Pillar contract was too deficient for commercial reality to save it.

## 2. Substance over Form

The substance over form doctrine represents a challenge of comprehension. The doctrine is applied in two different ways: one version is in accordance with the *Duke of Westminster* principle and the other is not. Unfortunately, it appears that, at the time of GAAR's enactment, the courts had not yet differentiated the two of them. Neither had they defined the terms "substance" and "form".

The substance over form doctrine, which was in accordance with the *Duke of Westminster* principle, has more affinities with interpretation techniques (albeit interpretation of contracts as opposed to interpretation of a statute) than with judicial anti-avoidance doctrines. Its primary purpose is not to circumscribe tax avoidance but to discover the true legal implications of a

transaction. Under this doctrine, the courts look at the substance of the transactions to determine their legal results and tax consequences. Such an application of the doctrine is based upon the principle that the term used to describe a legal relationship is not necessarily determinative of its real nature: anyone can take a "Sale-Purchase Agreement" and change its appellation to "Lease Agreement", but the fact of the matter remains that the agreement is a "Sale-Purchase Agreement".

In this version of the doctrine, the terms "substance" and "form" are implicitly given the following meanings:

- (a) "substance" is interpreted as referring to the true legal results of the transaction as inferred from objective evidence; and
- (b) "form" is interpreted as referring to the formal characterization given to the transaction by the parties to it.

In the above example, the form of the transaction would be the appellation given to it, either "Lease Agreement" or "Sale-Purchase Agreement". The substance of the transaction would be the facts necessary to its completion. For instance the wording of the agreement, negotiation of mortgages, exchange of money, transfer of title, etc. would be as many facts that would allow the courts to characterize properly the transaction as a Purchase and Sale, notwithstanding the appellation it was given.

Where this version of the doctrine applies and permits the conclusion that there are discrepancies between the substance and the form of a transaction, it is arguable that a sham transactions doctrine argument would also succeed. (It would fail if the discrepancies are the result of incompetence because the intention element of a sham is absent.)<sup>70</sup> In *M.N.R. v. Cox*

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<sup>70</sup> *Infra* note 109 and accompanying text.



*Estate*,<sup>71</sup> the court considered whether an exchange of cheques was an attempt to create two transactions, a gift of money by a husband to his wife and the wife's purchase of the life insurance policy on her husband's life. Since there were not sufficient funds to honour both cheques, the court found that the two transactions could only be viewed as one and therefore concluded that the true legal result of the transaction was the gift of the husband's policy to his wife, not its purchase by the wife. In *McCreath Trust v. M.N.R.*, the court embraced the following reasoning:

No ordinary person would consider as true sale ... a transaction by which an asset is transferred from a vendor to a purchaser and the monies used to purchase the asset are those of the vendor ...

The obvious intent was in essence to effectuate a gift and no true purchase ... took place ... One must look at the essence and not merely at the form. ...

The realities of the situation must always be considered.<sup>72</sup>

It is arguable that, in both cases, a sham transactions doctrine argument would have succeeded.

To support its conclusion, the latter case relied on a statement of Kerr J. in *West Hill*

*Redevelopment Co. v. M.N.R.*:

Coming now to the consideration of the question of the character of the transaction or arrangements by which the payments in question were made, it is well settled that in considering whether a particular transaction brings a party within the terms of the *Income Tax Act* its substance rather than its form is to be regarded, and also that the intention with which a transaction is entered into is an important matter under the Act and the whole sum of the relevant circumstances must be taken into account.<sup>73</sup>

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<sup>71</sup> [1971] S.C.R. 817, [1971] C.T.C. 227, 71 D.T.C. 5150 (S.C.C.) [hereinafter referred to as *Cox Estate* cited to D.T.C.].

<sup>72</sup> [1982] C.T.C. 36, 81 D.T.C. 5338 (F.C.T.D.) [hereinafter referred to as *McCreath Trust* cited to D.T.C.] at 5344.

<sup>73</sup> [1969] C.T.C. 581, 69 D.T.C. 5383 (Ex. Ct.) [hereinafter referred to as *West Hill Redevelopment* cited to D.T.C.] at 5392. It should be noted that this case coupled the substance over form doctrine with the ineffective transactions, sham transactions and business purpose test doctrines.

Ironically, it is not clear whether this statement supports the first version of the doctrine or the second.

Unlike the first version of the doctrine, the second is definitely a judicial anti-avoidance doctrine. Under the second version, the courts ascertain the tax implications of a transaction by looking at its economic consequences rather than its legal ones. A study of the case law permits one to infer that the following meanings were read into the terms "substance" and "form":

- (a) "substance" was interpreted as referring to the economic consequences or economic reality of a transaction; and
- (b) "form" was interpreted as referring to the legal framework of a transaction.

Before *Stuart*, the first version of the doctrine appeared to prevail. In *Stuart*, the Supreme Court of Canada recognized a special and independent status in Canadian taxation law to the sham transactions and ineffective transactions doctrines.<sup>74</sup> According to *Stuart*, all the other doctrines would have to be developed within the ambit of former subsection 245(1) and apart from an invitation to look at the commercial reality of a transaction in the specific context of the ineffective transactions doctrine, the Court does not elaborate on the substance over form doctrine. The "after-*Stuart*-cases", however, have filled in the gap.

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<sup>74</sup> *Stuart*, *supra* note 3 at 6321:

In Canada the sham concept is at least a judicial measure for the control of tax abuse without specific legislative direction. The judicial classification of an ineffective transaction is another.

The most remarkable illustration of the development of the doctrine after *Stubart* was handed down by the same Court in *M.N.R. v. Bronfman Trust*.<sup>75</sup> The Court had the following comments, which, as far as the mushrooming of the substance over form doctrine is concerned, are self-explanatory:

I acknowledge, however, that just as there has been a recent trend away from strict construction of taxation statutes, 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 ... "common sense appreciation of all the guiding features" of the events in question.

This is, I believe, a laudable trend provided it is consistent with the text and purposes of the taxation statute. Assessment of taxpayers' transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon the taxpayer's sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction.<sup>76</sup>

Other cases also revealed the new strength of the doctrine.<sup>77</sup>

Despite frequent applications, the second version of the doctrine has not developed any real pattern of application. It seems as though the judges have applied it irrationally whenever

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<sup>75</sup> [1987] 1 S.C.R. 32, [1987] 1 C.T.C. 117, 87 D.T.C. 5059 (S.C.C.) [hereinafter referred to as *Bronfman Trust* cited to D.T.C.].

<sup>76</sup> *Ibid.* at 5066, 5067.

<sup>77</sup> *Montgomery v. M.N.R.*, [1987] 2 C.T.C. 2023, 87 D.T.C. 355 (T.C.C.) at 357, 358:

The series of transactions taken by the appellant must be examined in light of substance rather than form. While the transactions appear to be *bona fide*, it must be determined whether in fact a true Employees Pension Sharing Plan had been properly set up. ... There is not doubt that all necessary documentation was carefully drawn by the appellant to give the appearance of the *bona fide* Employees Pension Sharing Plan and that in fact was not *bona fide*, it was a sham or plan designed to artificially reduce tax liability. ... The whole arrangement, on the face of it, was seemingly proper and legal. When the veil of legitimacy is pierced, the true nature of the Employees Pension Sharing Plan and the trust agreement becomes clear.

It is worthwhile noting that this case coupled the substance over form doctrine with the sham transactions and series of transactions doctrine, and former subsection 245(1). See also: *MSS Inc. v. M.N.R.* (1986), 9 F.T.R. 171, [1987] 1 C.T.C. 130, 87 D.T.C. 5088 (F.C.T.D.); *Irving Oil*, *supra* note 54, in which case the substance over form doctrine was also coupled with the sham transactions doctrine.

they felt that one party should prevail over the other, but did not know how to reach rationally such a conclusion. Another feature of the doctrine is that it does not exist on its own. It has always been coupled, whether expressly or inconspicuously, with another doctrine.

In conclusion, unless the doctrine had been thoroughly analyzed and coherently articulated by the courts, it is doubtful that it could have offered serious help to the Minister of National Revenue in his war against tax avoidance; as it was, the doctrine was too fluid and its outcome, a gamble.

### 3. Business Purpose Test

As in Canadian taxation law, tax liability should be assessed on the legal results of the taxpayers' transactions, Canadian courts have generally turned down business purpose arguments<sup>78</sup>:

... I might point out that, under the Act as it is at the present time, the situation would be no different even if one of the elements in the transaction was the avoidance of taxes. There is indeed no provision in the *Income Tax Act* which provides that, where it appears that the main purpose or one of the purposes for which any transaction or transactions was or were effected was the avoidance or reduction of liability to income tax, the Court may ... direct that such adjustments shall be made ... so as to counteract the avoidance or reduction of liability to income tax ...<sup>79</sup>

There have been, however, a few departures from this attitude upon which the business purpose test doctrine has materialized. This is probably due to Revenue Canada's insistence on bringing up business purpose arguments.

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<sup>78</sup> These arguments attempt to have transactions ignored for tax purposes when their main purpose is the avoidance of taxes.

<sup>79</sup> *Foreign Power Securities Ltd. v. M.N.R.*, [1966] C.T.C. 23, 66 D.T.C. 5012 (Ex.Ct.) at 5027. See also: *Produits L.D.G.*, *supra* note 48.

The business purpose test is a doctrine that Revenue Canada would certainly like to see have a widespread impact on Canadian taxation law; such a doctrine, which focuses on the necessity that a transaction have a business purpose distinct from that of saving tax money, is undoubtedly very appealing for Revenue's officials. Although business purpose arguments have been successful in a few cases, the doctrine has not been accorded an independent judicial standing.

I have already mentioned that, in the absence of a business purpose for a transaction, the transaction had to undergo a greater degree of scrutiny to satisfy the courts of its legal effectiveness.<sup>80</sup> A few cases also view the presence or absence of a business purpose in transactions as conclusive of whether or not the transaction is a sham.<sup>81</sup> In this regard, the decision of the Federal Court of Appeal in *Leon*, caused considerable uncertainty for the taxpayers. In that case, the Court held that a transaction having no business purpose amounts to a sham. If its *ratio* had withstood further judicial scrutiny, the case would have provided Revenue Canada with a powerful weapon. In equating an absence of business purpose with sham, *Leon* was either granting an independent judicial standing to the business purpose test doctrine or blowing out of proportion the sham transactions doctrine. In fact, it is not clear which one of the two doctrines was overtaking the other. Perhaps *Leon* could have been the indication of a new judicial doctrine: the "no business purpose/sham transactions doctrine"? However, the same Court in *Massey-Ferguson* later tried to limit the principle enunciated in *Leon* by restricting its application to the facts of that case, but the decision was ambiguous about

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<sup>80</sup> *Atinco Paper Products*, *supra* note 63; *Daly*, *supra* note 63.

<sup>81</sup> See e.g.: *Smythe v. M.N.R.*, [1967] C.T.C. 498, 67 D.T.C. 5334 (Ex.Ct.); *Dominion Bridge Co. v. M.N.R.*, [1975] C.T.C. 263, 75 D.T.C. 5150 (F.C.T.D.); *Leon v. M.N.R.*, [1976] C.T.C. 532, 76 D.T.C. 6303 (F.C.A.) [hereinafter referred to as *Leon* cited to C.T.C.]; *Agar v. M.N.R.*, [1980] C.T.C. 397, 80 D.T.C. 6311 (F.C.T.D.).

what part of the principle exactly was limited to such facts. In the end, it seems that the courts have since abandoned the idea of such "new doctrine".

Again, *Stubart* played an important role in the development of the business purpose test. The parties admitted that the transactions entered into by Stubart Investments Ltd. had no independent business purpose, apart from the reduction of taxes. The Minister submitted that a transaction entered into with no independent, or *bona fide*, business purpose is not, by virtue of that sole fact, a valid transaction for income tax purposes. The Court rejected the Minister's proposition:

I would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or *bona fide* business purpose.<sup>82</sup>

It nonetheless agreed that such a doctrine could develop within the scope of subsection 245(1).<sup>83</sup> Strayer J., in *Consolidated-Bathurst, FCTD*, did not understand it "to mean, however, that the presence of a *bona fide* business purpose necessarily makes section 137, or its successor, inapplicable".<sup>84</sup>

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<sup>82</sup> *Stubart*, *supra* note 3 at 6322.

<sup>83</sup> *Ibid.* at 6323, 6324:

Where the facts reveal no bona fide business purpose for the transaction, s. 137 may be found to be applicable depending upon all the circumstances of the case.

<sup>84</sup> *Supra* note 19 at 5124.

Suffice it to say that *Stubart* closes the door to an independent business purpose test doctrine in Canadian taxation law. Rather, it suggests an interpretation technique turning upon the "object and spirit" of the *Act*:

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.<sup>85</sup>

This "object and spirit" approach was not totally unknown to Canadian courts,<sup>86</sup> but was consecrated in *Stubart* and followed thereafter.<sup>87</sup>

#### 4. Sham Transactions

The sham transactions doctrine is also a corollary to the *Duke of Westminster* principle. It is relied upon in circumstances where the acts and documents of the parties appear to create legal results that are different than the intended ones. If a court concludes that a transaction is a sham, the tax liability of the taxpayer is again determined by reference to the true legal results rather than by reference to the pretence of results.

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<sup>85</sup> *Stubart*, *supra* note 3 at 6322.

<sup>86</sup> *Alberta and Southern Gas*, *supra* note 17.

<sup>87</sup> *Bracken v. M.N.R.*, [1984] C.T.C. 2922, 84 D.T.C. 1813 (T.C.C.); *Qualico Developments Ltd. v. The Queen (No. 1)*, [1984] C.T.C. 122, 84 D.T.C. 6119 (F.C.A.); *Edmonton Liquid Gas*, *supra* note 49.

The theory of the sham transactions doctrine was "prophesied" by Lord Tomlin:

There may, of course, be cases where documents are not *bona fide* nor intended to acted upon, but are only used as a cloak to conceal a different transaction.<sup>88</sup>

The leading case on this matter remains, however, the English case *Snook v. London & West Riding Investments Ltd.* which gave the doctrine its definition:

... if it [sham] has any meaning in law, it means act done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to 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. One thing I think, however, is clear in legal principle, morality and authorities, that for facts or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a "shammer" affect the rights of a party whom he deceived.<sup>89</sup>

The *Snook* definition of a sham was adopted in Canadian taxation law in *M.N.R. v. Cameron*<sup>90</sup> and echoed thereafter.<sup>91</sup>

Despite a rather straightforward definition, the application of the sham transactions doctrine has been inconsistent, unpredictable and distorted by the conjunctive and unharmonious application of other judicial anti-avoidance doctrines to it.<sup>92</sup> In *Leon*, the Federal Court of

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<sup>88</sup> *Duke of Westminster*, *supra* note 57 at 21.

<sup>89</sup> [1967] 1 All. E. R. 518 [hereinafter referred to as *Snook*] at 528.

<sup>90</sup> [1972] C.T.C. 380; 72 D.T.C. 6325 (S.C.C.).

<sup>91</sup> *Antoine Guertin*, *supra* note 14; *Don Fell*, *supra* note 38; *Bonavista Cold Storage*, *supra* note 38; *Indalex*, *supra* note 66; *Irving Oil*, *supra* note 54; *Esskay Farms*, *supra* note 30; *Sigma Explorations*, *supra* note 37; *Spur Oil*, *supra* note 42; *Mendels*, *supra* note 23.

<sup>92</sup> *Leon* is a perfect example of conjunctive and unharmonious application of the business purpose test to the sham transactions doctrine. *Leon*, *supra* note 81 at 539:

For the respondents to be successful in this appeal they must established a *bona fide* business purpose in the transaction, which on the evidence in these cases, they have failed to do. It is the agreement or transaction in question to which the Court must look. If  
(continued...)



Appeal construed the sham transactions doctrine as though it embodied a *sine qua non* business purpose test: "if the agreement lacks a *bona fide* business purpose, it is a sham".<sup>93</sup> If this were true, why did two distinct doctrines exist? To be logical, in accordance with the Court statement in *Leon*, only the sham transactions doctrine should be part of Canadian taxation law for which the requirement of a business purpose would be an element and would not have its own standing as an anti-avoidance doctrine.

The principle established in *Leon* created uncertainty with respect to its own application and interpretation.<sup>94</sup> In this regard, *Stubart* was welcome. It reduced the uncertainty which had surrounded the sham transactions doctrine since *Leon*. An element of intention to deceive is required, and the absence of a business purpose to a transaction does not fulfil this requirement:

This expression comes to us from a decision in the United Kingdom, and it has been generally taken to mean (but not without ambiguity) a transaction conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away from the taxpayer or the true nature of the transaction; or, simple deception whereby the taxpayer creates a facade of reality quite different from the disguised reality.<sup>95</sup>

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<sup>92</sup>(...continued)

the agreement or transaction lacks a *bona fide* business purpose, it is a sham.

Ironically, the same Court, the same year, also stated in *Produits L.D.G.*, *supra* note 48 at 6348:

We must remember that this English word [sham] does not have any magical qualities.

A sham is a pretence, that is in law, a fictitious or bogus act.

No reference was made to the necessity of proving a business purpose test to salvage the transaction from being a sham. According to this statement, the sham transactions doctrine seemed to be exactly as it had been described in *Snook*, *supra* note 89.

<sup>93</sup> *Ibid.*

<sup>94</sup> See e.g.: *Massey-Ferguson*, *supra* note 57; *Mendels*, *supra* note 23.

<sup>95</sup> *Stubart*, *supra* note 3 at 6308. See also: *Indalex*, *supra* note 66 at 6044, 6045:

Thus the sham test when applied as a general principle of statutory interpretation requires that for a transaction to be disregarded by the Court it must exhibit an element of deception, not merely be found to have no business purpose other than tax avoidance.

In my opinion, Estey J.'s interpretation of the sham transactions doctrine simply restores the doctrine as enunciated in *Snook*, and distances it from the other judicial anti-avoidance doctrines: it revives the *Duke of Westminster* principle.

In 1987, in *M.N.R. v. Bronfman Trust*<sup>96</sup>, the Supreme Court of Canada seemed to ignore its own position in *Stubart*. It equated sham to artificiality and juxtaposed sham and substance over form. If this latest position were to stand, the sham transactions doctrine would be expanded. Needless to say, the state of law on this matter was confusing at the time of GAAR's conception.

## 5. Step Transactions

The step transactions doctrine has received very little and mostly indirect attention from Canadian courts. The doctrine is more popular in the United Kingdom and the United States.<sup>97</sup> However, as a matter of general understanding, the doctrine applies to multiple steps transactions when the insertion of steps in the transactions is for the purpose of mitigating one's tax liability.

The confusing state of the law relative to the step transactions doctrine in Canadian taxation law is well illustrated by two cases: *West Hill Redevelopment*<sup>98</sup> and *Cox Estate*.<sup>99</sup> In *West Hill Redevelopment*, the taxpayer's scheme to reduce its tax liability revolved around the creation of a pension plan. The judge's reasoning was rather chaotic. Kerr J. commenced

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<sup>96</sup> *Supra* note 75.

<sup>97</sup> See: pp.71-75, and 77 below. The doctrine is probably more popular in both countries than in Canada because neither have a legislative general anti-avoidance provision, or a perceived one. In this regard see: *supra* note 109 and accompanying text.

<sup>98</sup> *Supra* note 73.

<sup>99</sup> *Supra* note 71.

with the premise that "in considering whether a particular transaction brings a party within the terms of the *Income Tax Act* its substance rather than its form is to be regarded."<sup>100</sup> Having stated this premise, Kerr J. determined that the issue at stake was whether the particular transaction was a sham. He then noted that it might be arguable that West Hill Redevelopment had a business purpose but that the answer lay in the truthfulness of the pension plan. The intention of the taxpayers with respect to the use of the plan led Kerr J. to conclude that the transaction was a sham and that as such would not resist to an attack under section 137. As if this were not enough, he also questioned, without resolving the issue, the legal effectiveness of the transaction. He finally introduced the step transactions doctrine to conclude that the plan was a sham:

The scheme was ingenious and was pursued step by step, but the steps add up to one large stride intended, in my opinion, not really to provide pensions but predominantly to achieve for the company a substantial deduction from income. ... If a claim for deduction of payments into a pension plan is to succeed the plan must be a true pension plan and not a plan which masquerades as a true pension plan but is not one.<sup>101</sup>

In summary, Kerr J.'s reasoning bounced from substance over form to sham to business purpose, then back to sham, then to ineffective transaction, to step transaction, and back to sham once again. In *Cox Estate*, the Supreme Court of Canada inadvertently (or at least it is to hope so) melded the step transactions and substance over form doctrines together.

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<sup>100</sup> *Supra* note 73 at 5392.

<sup>101</sup> *Ibid.* at 5394.

C. *Stubart Investments Ltd. v. M.N.R.*

*Stubart* played a pivotal role in the enactment of GAAR. In that case, the Supreme Court of Canada conclusively turned down a series of attempts by the Minister of Finance to have the business purpose test recognized as an independent judicial anti-avoidance doctrine in Canadian taxation law. Moreover, in the process, the Court reviewed and redefined a few other anti-avoidance doctrines. Seemingly, the Minister found the conclusions to be too restrictive and he responded with GAAR.

The case involved the sale and purchase of the assets of one sister corporation, *Stubart Investments Ltd. ("S")*, to and by another sister corporation, *Grover Cast Stone Company Limited ("G")*. Each of the sister corporations conducted a different business. While G had incurred substantial losses, S's business was profitable. In order to benefit from the loss carry-forward provisions of the *Act*, the tax advisers of the parent corporation suggested a scheme to recuperate these losses through a sale-purchase agreement: G being the purchaser and S, the vendor. A concurrent agreement designated S as G's agent to carry on the newly transferred business. As part of the deal, it was intended that the assets of S be sold back to it after all of G's losses had been used up. This intention was not, however, carried through. Revenue Canada reassessed S for the income earned for and to the account of G on the basis that the transaction was a sham, incomplete and had no business purpose whatsoever. S appealed the reassessment.

The Tax Appeal Board<sup>102</sup> and the Federal Court, Trial Division<sup>103</sup> dismissed the appeal, on the basis that the transaction was a sham. The Federal Court of Appeal<sup>104</sup> affirmed the dismissal but on the basis that the transaction was ineffective and found it unnecessary to reach a conclusion on the sham issue. The Supreme Court of Canada reversed all three judgments and found that the transaction was not a sham, that the transaction was complete and effective and that the business purpose test had no application.

The Minister of National Revenue did not rely upon any express provision of the *Act* as authority for the reassessment of S. Instead, the Minister asked the Court to find that the absence of a valid business purpose to a transaction constituted sufficient authority for a reassessment:

... the respondent asks 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 business purpose. The respondent asserts that, by definition, an independent business purpose does not include tax reduction for its own sake.<sup>105</sup>

In the alternative, the respondent submitted that the transaction was incomplete and as such ineffective.

The Supreme Court divided its analysis of the case into four issues. It recognized two main issues: incomplete transactions and business purpose, and two subsidiary issues: sham and artificial transactions.

With respect to the sham transactions, the Court confirmed that the state of the law on the matter, in Canada, had not deviated from that of its origins in the United Kingdom. The

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<sup>102</sup> 74 D.T.C. 1209 (T.A.B.).

<sup>103</sup> [1978] C.T.C. 612, 78 D.T.C. 6414 (F.C.T.D.).

<sup>104</sup> [1981] C.T.C. 168, 81 D.T.C. 5120 (F.C.A.).

<sup>105</sup> *Stuart*, *supra* note 3 at 6308.

Court reiterated that an element of deceit is required for a transaction to be a sham, such element of deceit aiming, of course, at deluding the tax collector. This interpretation is in perfect accordance with the definition given in *Snook*. With respect to section 137, the Court only referred to it to admit (although it reserved its opinion on the outcome) that it would have been applicable to the facts of the case had the Minister relied upon it in its argument.

The Court then turned to an analysis of the two major issues. The first major issue to be examined was the issue of incomplete transactions, or the ineffective transactions doctrine. In the course of the completion of the transaction, G had undertaken thirty legal steps. Nonetheless, the Minister of National Revenue submitted three arguments, to which the Court added a fourth one, supporting the conclusion that the transaction was ineffective:

- (a) in filing its annual returns, G disclosed only its old business regardless of the one acquired from S, but it disclosed both businesses in filing its income tax returns;
- (b) after the sale of its assets, S continued to hold a license under the *Excise Act*;
- (c) the T4 slips of the employees were completed by S; and
- (d) a memo of S's solicitor referred to an eventual sale of the assets back to S after G had used up all its losses.

The Court considered each of the above arguments and forged for each of the arguments a plausible rationale to frustrate them. However, the court's final and decisive conclusion was that "faced with this commercial reality, it is difficult to see how the transaction ... was incomplete."<sup>106</sup>

Such conclusion introduces a new concept into the ineffective transactions doctrine. That simple and seemingly inoffensive statement opens an all new line of defence to the taxpayers.

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<sup>106</sup> *Ibid.* at 6311.

Indeed, although reliance on commercial reality seems inoffensive, its lack of boundaries makes it precarious. Taken to an extreme, this opening could allow the taxpayers to have their tax liability assessed on the basis of a factual realization of a transaction even though the intended legal results are not achieved in law.

Recourse to commercial reality to reject the Minister's arguments was foolish, unwarranted and unnecessary. Arguments (a) and (b), at the most, disclose the avoidance purpose of the transaction, and purpose is not reprehensible under the ineffective transactions doctrine. Whatever the characteristics attributed to those arguments, they are legally insufficient, without regard to the commercial reality, to nullify the legal effectiveness of the transaction. With respect to argument (c), it is simply not a valid argument. A corporate agent can legitimately have its own employees. Finally, argument (d) is a logical argument applied in the wrong context. Such an argument belongs to the sphere of the step transactions doctrine.<sup>107</sup> In light of this review of the arguments, it is clear that commercial reality was gratuitously raised to defeat the Minister's arguments.

Having dealt with the issue of ineffective transactions, the Court turned to the most important issue of the business purpose test, which it examined at length. The Court started with the premise that an otherwise lawful act does not become unlawful by reason only of its motives.<sup>108</sup> Then, the Supreme Court looked at the American, Australian and English jurisprudence and lastly at the Canadian jurisprudence. It conceded that American courts had adopted, in certain circumstances, the business purpose test. It pointed out, however, that the application of the doctrine was limited to tax planning involving corporate reorganizations and

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<sup>107</sup> The step transactions doctrine is not relied upon in *Stubart*.

<sup>108</sup> *Bradford (Mayor) v. Pickles*, [1895] A.C. 587 (H.L.); *Duke of Westminster*, *supra* note 57.

that, unlike our federal tax statute, the American tax statute did not have a general provision limiting tax avoidance.<sup>109</sup> In Australia, the courts stayed clear of judicial anti-avoidance doctrines since the Australian tax statute embodied a general anti-avoidance provision. In reviewing the English jurisprudence, the Court reformulated the business purpose test issue. The English courts had elaborated a judicial doctrine which is usually referred to as the step transactions doctrine. Under this doctrine, "if the transaction consists of a series of transactions or a composite transaction and is accompanied by or includes steps which have no business purpose, then the result is taxation."<sup>110</sup> In such cases, the courts look at the end result and ignore the steps taken. As for the American tax statute, the United Kingdom tax statute contains no general provision. For Canadian taxation purposes "[h]owever, there remains the larger issue as to whether Canadian law recognizes, as a principle of interpretation, that the conduct of the taxpayer, not dictated by a genuine business purpose, and being designed wholly for the avoidance of tax otherwise impacting under the statute, can be set aside ..."<sup>111</sup>

A review of the Canadian jurisprudence prompted the Court to conclude that neither as an independent judicial doctrine, nor as a tool of interpretation of section 137, was the status of the business purpose test settled in Canadian taxation law. Nevertheless, by reason of the complexity of the taxation policies which combined both "fiscal and economic policy"<sup>112</sup> the

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<sup>109</sup> Despite Estey J.'s understanding of it, former subsection 245(1), albeit the most general anti-avoidance provision of the *Act*, was not a general anti-avoidance provision because it did not apply in all circumstances; it applied, albeit with some controversy, to deductions made in computing either the income or taxable income of the taxpayers; it did not, however, apply to deductions made in computing the amount of tax payable; the deductions would also have to be made with respect to a disbursement or expense therefore excluding from former subsection 245(1)'s scope of application all reserves taken for money to be received; and moreover, the deductions would have to unduly or artificially reduce the income.

<sup>110</sup> *Stuart*, *supra* note 3 at 6316.

<sup>111</sup> *Ibid.* at 6317.

<sup>112</sup> *Ibid.* at 6322.



Court rejected a strict business purpose test. Based on the same premise, however, the Court concluded that it should interpret the *Act* according to "the object and spirit" of the taxing provisions, noting also that it had already distanced itself from the rule of strict interpretation:

Gradually, the role of the tax statute in the community changed, ..., and the application of strict construction to it receded. Courts today apply to this statute the plain meaning rule, but in a substantive sense so that if a taxpayer is within the spirit of the charge, he may be held liable.<sup>113</sup>

Unfortunately, the Court failed to define what it meant by "object and spirit". It also failed to explain how these words should be interpreted, and to determine how and what tools of interpretation would reveal that "object and spirit".

Nonetheless, the Court enunciated a few guidelines which were "for the guidance of a court faced with this interpretative issue".<sup>114</sup> The first guideline states:

1. Where the facts reveal no *bona fide* business purpose for the transaction, s. 137 may be found to be applicable depending upon all the circumstances of the case.<sup>115</sup>

I have already suggested that any reference to a business purpose was entirely irrelevant to a finding on the applicability of former subsection 245(1), and that the words "unduly" and "artificially" demand objective evidence based on the facts of the case, regardless of the taxpayer's purpose. It is unfortunate that the Court brought the emphasis back to the purpose of the transaction.

Estey J.'s first guideline presupposes that a transaction having a *bona fide* business purpose is not caught by subsection 245(1). Although such premise is correct, it wrongly focuses on the purpose of the transaction. It is not the purpose of the transaction that saves it,

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<sup>113</sup> *Ibid.* at 6323.

<sup>114</sup> *Ibid.* at 6323.

<sup>115</sup> *Ibid.* at 6323, 6324.

but the fact that transactions having such a *bona fide* purpose do not unduly or artificially reduce the income. Certainly, the presence of a business purpose is incidental to many conclusions under former subsection 245(1), the same as being dressed insufficiently is incidental to catching a cold, but was in no way conclusive. A cold is caught when one has contracted the cold virus; in a parallel manner, former subsection 245(1) applies when there has been undue or artificial reduction of income regardless of the purpose of the transaction.

The second guideline stated:

2. In those circumstances where s. 137 does not apply, the older rule of strict construction of a taxation statute, as modified by the courts in recent years, prevails but will not assist the taxpayer where:
  - (a) the transaction is legally ineffective or incomplete; or,
  - (b) the transaction is a sham within the classical definition.<sup>116</sup>

In its second guideline, the Court confirms the existence of the ineffective transactions and sham transactions doctrines in Canadian taxation law. One may wonder why the Court refused to apply a business purpose test outside the ban of former subsection 245(1) but adopted the free application of the two above doctrines. The answer is simple. These two doctrines are in concordance with the *Duke of Westminster* principle. Ironically, while embracing doctrines in harmony with this principle of taxation, the Court also jeopardized this very harmony. The court's reliance on commercial reality to circumvent the Minister's ineffective transactions arguments runs afoul of the principle. The doctrine which once was corollary to the principle, as it reinforced the duty to assess tax on the basis of the legal results of a transaction, was breached to allow the substance of transactions to take precedence.

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<sup>116</sup> *Stubart*, *supra* note 3 at 6324.

Finally, in its third guideline, the Court states:

3. Moreover, the formal validity of the transaction may also be insufficient where:

- (a) the setting in the Act of the allowance, deduction or benefit sought to be gained clearly indicates a legislative intent to restrict such benefits to rights accrued prior to the establishment of the arrangement adopted by a taxpayer purely for tax purposes;
- (b) the provisions of the Act necessarily relate to an identified business function. ...;
- (c) "the object and spirit" of the allowance or benefit provision is defeated by the procedures blatantly adopted by the taxpayer to synthesize a loss, delay or other tax saving device, although these actions may not attain the heights or "artificiality" in s. 137.<sup>117</sup>

This third interpretative approach is somewhat refreshing in the sense that it focuses on the purposes and intentions of the provisions of the *Act* rather than those of the taxpayers. However, the third guideline is deficient as it does not specify the scope of the words and expressions it employs. For instance, what does "blatantly" mean? Neither does it specify how the purpose of the provisions of the *Act* is to be ascertained. It was a laudable attempt by the Court to give a new perspective to the interpretation of the *Act*, but the Court was not as categorical as the Minister would have liked it to be.

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<sup>117</sup> *Ibid.* at 6324.

Numerous objections to, and few approvals of, the proposed general anti-avoidance rule were brought before the House of Commons upon its introduction as a Bill.<sup>1</sup> There was an interesting dichotomy in the nature of interests protected by those rejecting and those endorsing the implementation of a general anti-avoidance rule. While business and professional associations objected to GAAR, academics, labour and social welfare groups supported it. On the one hand, if tax avoidance was not rendered more difficult, people engaged in business activities could make high use of tax planning to mitigate their tax liability. Of course, in the process, tax professionals could put their hands on some of the tax dollars saved. The tax burden would then be shifted to the others, thereby jeopardizing the fairness and equity of the taxation system. To the contrary, if tax avoidance was rendered more difficult, people engaged in business activities would pay more taxes which would lighten the tax burden of the others. This would contribute to a fairer and more equitable system. Unfortunately, human nature is such that fairness and equity become less attractive when you are the one benefiting from unfairness and inequity.

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<sup>1</sup> The disproportionate number of objections to the rule compared with the number of approbations is rather diplomatically implied by the Standing Committee on Finance and Economic Affairs in : Canada, Parliament, House of Commons, Standing Committee on Finance and Economic Affairs, *Tax Reform '87: Report of the Standing Committee on Finance and Economic Affairs tabled in the House of Commons on November 16, 1987* (Don Mills, Ontario: Richard De Boo, 1987) at 194:

The Committee heard *strong* objections to the introduction of this proposed rule from groups such as the *Canadian Organization of Small Business*, *Canadian Federation of Independent Business*, *Canadian Bar Association*, *Canadian Petroleum Association*, the *Canadian Institute of Chartered Accountants*, *Retail Council of Canada*, and the *Canadian Cattlemen's Association*. Other organizations such as the *Canadian Federation of Labour* approved of the government's introduction of the proposed general anti-avoidance rule.

Those engaged in, and relying on, tax planning<sup>2</sup> perceived GAAR as an authentic "sword of Damocles". They rallied against perceived technical imperfections in GAAR and discounted the policy considerations that led to it.<sup>3</sup> Shouting louder than academics, labour and social welfare groups, the business and professional associations embroiled the enactment process of GAAR in controversy.

Why did the government enact GAAR? We can better understand the decision once we analyze its political history. This analysis is undertaken in four steps. The first step studies the 1987 Tax Reform [hereinafter referred to as the "Reform"] as the instrument of enactment of GAAR. The second step reviews the specific factors which predisposed the Department of Finance and Revenue Canada to rearrange their anti-avoidance measures. The third step, syllogistically flowing from the first and second, examines the different anti-avoidance alternatives which were available to the Department and the parameters within which GAAR was construed. The fourth step discusses the outcome, which is GAAR itself.

#### A. Context of Enactment

The Reform brought GAAR into the taxation system. The spirit of the Reform, especially the objectives of fairness, competitiveness and reliability, influenced the choice of the anti-avoidance techniques which were regarded as being proper methods to contend with

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<sup>2</sup> See for instance the groups objecting to GAAR in *supra* note 1.

<sup>3</sup> *Ibid.* See also: Howard J. Kellough, "A Review and Analysis of the Redrafted General Anti-Avoidance Rule", (1988) 36 Can. Tax J. 23-78; Howard J. Kellough, "Tax Reform and the Anti-Avoidance Proposals", 1987 *British Columbia Tax Conference*, Toronto, C.T.F., 1988, 6:1-82; David C. Nathanson, "The Proposed General Anti-Avoidance Rule", *Report of the Proceedings of the Thirty-Ninth Tax Conference* (1987 Conference Report), Toronto, C.T.F., 1988, 9:1-27.

unacceptable (from the government's perspective) tax avoidance schemes. A review of the Reform's characteristics pertinent to GAAR's enactment is structured along two lines: the essence of the Reform and its noteworthy aspirations.<sup>4</sup>

### 1. Essence of the Tax Reform

The Reform was part of an ongoing reformatory process which commenced in September 1984, with the "*Agenda for Economic Renewal*", wherein the government identified four challenges:

- (a) to restore fiscal responsibility;
- (b) to remove obstacles to growth;
- (c) to foster investment, innovation and competitiveness; and
- (d) to provide greater assistance to those Canadians who truly need it.<sup>5</sup>

In pursuit of these challenges, the government published, in 1985, a discussion paper on the reform of the corporate income tax, considered options for a reform of the sales tax, examined the social transfer programs and their related tax provisions for an improved integration of both the social and taxation systems, and attempted to curtail the proliferation of tax avoidance activities.<sup>6</sup>

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<sup>4</sup> The present paper, dealing with tax avoidance and the general anti-avoidance rule, does unfortunately not offer the opportunity for a comprehensive review of the Tax Reform of 1987. Therefore, the reader should interpret the words according to the specific context of the paper and not pejoratively, in implying that what is omitted is not worthy.

<sup>5</sup> Canada, Department of Finance, *The White Paper on Tax Reform 1987 by the Honourable Michael H. Wilson Minister of Finance* (Ottawa: Department of Finance, on June 18, 1987) [hereinafter referred to as the *White Paper*] at 1.

<sup>6</sup> Canada, Department of Finance, *Income Tax Reform by the Honourable Michael H. Wilson Minister of Finance* (Ottawa: Department of Finance, on June 18, 1987) [hereinafter referred to as *Income Tax Reform*] at 1. "Overuse" of the scientific research tax credit, carve-out arrangements, abusive use of limited partnerships, Skytrain financing, Genstar Trust, and ITC sales are as many examples of tax avoidance activities.

The aforementioned actions, however, did not prove to be as fruitful as desired. "As it became increasingly apparent that the Canadian tax system was not performing many of its functions as well as it should, it became clear that the process of evolutionary and incremental reform, which had been in progress, would need to be greatly accelerated."<sup>7</sup> Moreover, Canada's primary trading partner, the United States of America, had entered, in 1986, upon "the most sweeping and revolutionary tax changes of its history"<sup>8</sup>:

It also became evident through this period that some of our major trading partners, ..., were moving forward more aggressively and more comprehensively with actions to reform their tax systems and, in particular, to lower their tax rates. In an increasingly interdependent world, it is important not to allow Canada's tax system to put our traders, businesses, investors and highly skilled individuals at a competitive disadvantage with other countries.<sup>9</sup>

The American Tax Reform resulted in, in essence, lower marginal tax rates -- the top personal tax rate was reduced to 28% while the top corporate rate was reduced to 34% -- and in a broader tax base.<sup>10</sup> The implications in Canada of such U.S. changes were fourfold:

- (a) disincentive for U.S. corporations to expand their affairs in Canada;
- (b) incentive for the Canadian "elite" to move to the U.S.;
- (c) incentive for profitable corporations to move to the U.S.; and
- (d) "temptation" to reallocate profits in the U.S and expenses in Canada.<sup>11</sup>

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<sup>7</sup> *White Paper*, *supra* note 5 at 21.

<sup>8</sup> Robert D. Brown, "Canadian Tax Reform: Can We Do Better the Second Time Around?", *Report of the Proceedings of the Thirty-Eight Tax Conference* (1986 Conference Report), Toronto, C.T.F., 1987, 3:1-31, at 3:1.

<sup>9</sup> *White Paper*, *supra* note 5 at 21.

<sup>10</sup> See: R. D. Brown, *supra* note 8; *White Paper*, *supra* note 5 at 22-23; J. Gregory Ballantine, "Tax Reform in the United States: Context and Effects", *Report of the Proceedings of the Thirty-Ninth Tax Conference* (1987 Conference Report), Toronto, C.T.F., 1988, 6:1-5.

<sup>11</sup> R. D. Brown, *supra* note 8 at 3:11-13. For further information on the effect of the U.S. Tax Reform on Canadians, see also: Robert H. Sharpenberg, "Tax Reform Act of 1986: Impact on Canadian Citizens Living or  
(continued...)

The U.S. Tax Reform certainly rendered Canada's domestic tax concerns even more dreadful.<sup>12</sup>

These two elements strongly argued in favour of an extensive tax reform. Indeed, despite efforts deployed to improve the taxation system, it was still deficient in a number of aspects. It fell short of providing a reliable source of revenues for the government, of discouraging tax avoidance enterprises and of ensuring the presence of equity in the system.

## 2. Noteworthy Aspirations of the Reform

The Reform endorsed five broad objectives: fairness, competitiveness, simplicity, consistency and reliability.<sup>13</sup> In order to meet these objectives the Reform was designed to occur in two stages. The first stage comprised a reform of the individual income tax, the corporate income tax, the reporting provisions, the non-compliance provisions and the anti-avoidance provisions. The second stage introduced the sales tax reform.

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<sup>11</sup>(...continued)

Working in the United States", *Report of the Proceedings of the Thirty-Eight Tax Conference* (1986 Conference Report), Toronto, C.T.F., 1987, Tab 28; Steve J. Cohen, "Canadian Investment in U.S. Real Property", *Report of the Proceedings of the Thirty-Eight Tax Conference* (1986 Conference Report), Toronto, C.T.F., 1987, Tab 29; Charles I. Kingson, "Liquidations, Branches and Losses: 1986 Changes in U.S. Tax Law", *Report of the Proceedings of the Thirty-Eight Tax Conference* (1986 Conference Report), Toronto, C.T.F., 1987, Tab 30; Richard A. Gordon, "The Tax Reform Act of 1986: Impact on U.S. Parent Corporations with Canadian Subsidiaries", *Report of the Proceedings of the Thirty-Eight Tax Conference* (1986 Conference Report), Toronto, C.T.F., 1987, Tab 31; Canada, Parliament, Senate, Standing Committee on Banking, Trade and Commerce, *Tax Reform '87: Twentieth Report of the Standing Senate Committee on Banking, Trade and Commerce tabled on December 1, 1987* (Don Mills, Ontario: Richard De Boo, 1987) at 12-13.

<sup>12</sup> In this regard, it should be noted that the Canadian government proceeded into a Two-Stage Tax Reform. It did so partially because it was not ready to proceed into the full reform. If the government was not ready to proceed into the full reform, why then, did it not wait to have one, true, comprehensive reform and with what would probably have been more accurate estimates of the revenues to be generated by the sales tax? It is presumed, in light of the circumstances, that the U.S. Tax Reform pressured the Canadian government into lowering its tax rates and not deferring its response to the U.S. Reform.

<sup>13</sup> *White Paper*, *supra* note 5 at 10.



The enactment of GAAR cut across all five objectives; nevertheless, this thesis only reviews those objectives that were most significant in giving birth to GAAR: fairness, competitiveness and reliability.

The Department of Finance's concern with fairness revolved around the requirement that the taxation system be vertically and horizontally equitable.<sup>14</sup> The Canadian taxation system with its high tax rates and numerous tax preferences created a pronounced incentive to avoid taxes, while providing taxpayers both the motive and the opportunity to do so. When embarking upon its Reform, "the government was concerned with the accelerating proliferation of tax avoidance schemes."<sup>15</sup> Such schemes had considerably eroded the tax base and undermined the fairness of the taxation system, especially with respect to the vertical equity of the individual income tax, and the horizontal equity of both personal and corporate income taxes.<sup>16</sup> While the introduction of the alternative minimum tax aimed at narrowing the disparity in the amount of tax paid, it did not directly attack the cause of such fluctuations, which was the proliferation of tax avoidance schemes through the use of special tax preferences. Those tax preferences,

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<sup>14</sup> I suggest that the word "fairness" was wrongfully used to describe the objectives of the Reform as "fairness" means more than "equity". See e.g.: Ontario, Fair Tax Commission, *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission: Highlights* (Toronto: University of Toronto Press, 1993).

<sup>15</sup> *White Paper*, *supra* note 5 at 55.

<sup>16</sup> An example of horizontal inequity is the following scenario: in 1984, the effective federal tax rate for individuals earning \$100,000 and over fluctuated between 0 and 30%. While 4% of them paid no tax, a further 58% paid taxes at rates varying between 20 and 30%. Another 26% were taxed at rates ranging from 10 to 20%. Furthermore, about 10% of the earners of \$100,000 and over were subject to a 0 to 10% tax rate. A horizontally equitable system would not yield such a high degree of variation. (*Income Tax Reform*, *supra* note 6 at 10, Table 2.2).

In the same year, vertical inequity was evidenced by the fact that while less than 58% of the same taxpayers were contained within a 20% differential tax rate bracket, over 90% of taxpayers with revenues up to \$75,000 were contained within a 10% differential tax rate. A vertically equitable system would see similar fluctuations of income tax payable from one income bracket to the others. (*Ibid.*)

Horizontal inequity also afflicted the corporate domain, with the average effective federal rate fluctuating across sectors. The mining sector and financial institutions, insurance and real estate, enjoyed a tax break on 50.2 and 51.3% of their income respectively. The agriculture, forestry and fishing, construction, wholesale, retail trade and services, in contrast, had 8.7, 3.9, 5.3, 1.1 and 5.9% of their income respectively which was not subject to tax. (*Ibid.* at 16, Chart 2.5).

whether used or abused,<sup>17</sup> were held directly responsible for this disparity. The threat to the fairness of the system is even more acute when one addresses issues such as who currently avoids taxes and who bears a "double" burden, as a result of others' tax avoidance. Although, by reason of the very nature of tax avoidance, it is extremely difficult to appraise how much tax revenues "are lost" through border-line avoidance schemes, it is relatively easy to guess who, or what, the tax avoiders were, and are. High income individuals and corporations probably benefited the most from the numerous tax preferences.<sup>18</sup>

Closely related to the objective of fairness, the Reform promoted reliability.<sup>19</sup> The introduction, in the 1970's and early 1980's, of a sizable number of preferences in the taxation system had led to the erosion of the tax base and equity of the system. It is also interesting to note that the tendency to adopt a stricter interpretation of former subsection 245(1) coincides

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<sup>17</sup> One could consider whether a usage of the tax preferences, which would respect the legislator's intent, should honestly result in "\$100,000-and-over-income-earners" paying as little tax as 0% and in a financial institution subtracting 51.3% of its income from tax liability. See also: *White Paper*, *supra* note 5; *Income Tax Reform*, *supra* note 6; David D. Dodge, "A New and More Coherent Approach to Tax Avoidance", (1988) 36 Can. Tax J. 1-22.

<sup>18</sup> To come to this conclusion, a simple look at the characteristics of tax avoidance is required. First of all, tax preferences are necessary and most tax preferences are corporate measures rather than individual measures. Secondly, tax avoidance requires knowledge of those preferences and of the taxation system. Thirdly, this knowledge is expensive. Finally, tax avoidance is only attractive when the amount of money saved on one's tax bill is greater than the amount of money expended on one's tax consultant's bill. An addition of all these characteristics confirms that high income individuals and corporations are the most likely to make use of tax avoidance schemes.

Moreover, the fact that the government wished primarily to introduce a *business purpose test*, not a *bona fide non tax purpose test*, presents a clear indicia that corporations were ahead in the game of avoidance plays. Twenty-nine examples of corporate and corporation related tax avoidance out of twenty-nine in the *Information Circular 88-2*, "General Anti-Avoidance Rule - Section 245 of the *Income Tax Act*", dated October 21, 1988, and in its first supplement, dated July 13, 1990, corroborates this presumption. See also implicative comments in: Canada, Department of Finance, *Economic & Fiscal Outlook* (Ottawa: Department of Finance, 1987) at 28; Canada, Department of Finance, *Tax Reform 1987: A Summary for Taxpayers* (Ottawa: Department of Finance, 1987) at 33, at which the introduction of GAAR was announced under the heading **Corporations Tax Measures**, also at 41 and 43. The government's concerns about corporate avoidance seem also to be of the understanding of R. D. Brown, *supra* note 8 at 3:14-15.

<sup>19</sup> *White Paper*, *supra* note 5 at 5: "[t]he tax system should provide a more reliable and balanced source of revenues to finance essential public services."

with the introduction of these preferences.<sup>20</sup> Each one of the preferences might have been a useful approach to address a particular concern but, "taken together, ..., the proliferation of special tax preferences put increasing pressure on the equity, efficiency and revenue stability of the income tax system."<sup>21</sup> The combination of high tax rates and the proliferation of tax preferences gave tax considerations a completely new importance in investment decisions. "Tax rates higher than necessary, together with special incentives, give tax planning rather than future profitability too large a role in investment decisions."<sup>22</sup>

Not only has this combination modified the importance of the various considerations pertaining to business decisions, but it has also modified the way they are carried out. "The government was concerned with the accelerating proliferation of tax avoidance schemes. Many opportunities for tax reduction occurred as a result of sophisticated strategies that often involved the combined or serial application of various technical provisions to yield unintended tax advantages."<sup>23</sup>

Both the objectives of fairness and reliability warranted the broadening of the tax base. This was accomplished through the removal of tax preferences in both individual and corporate income taxes,<sup>24</sup> and through an enlargement of the scope of products taxable under the sales

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<sup>20</sup> See: p.17 above.

<sup>21</sup> *White Paper*, *supra* note 5 at 8.

<sup>22</sup> *Ibid.* at 10.

<sup>23</sup> *Ibid.* at 55.

<sup>24</sup> For instance, the following tax preferences were removed or reduced:  
(a) the maximum lifetime capital gains exemption was limited to \$100,000 for all property other than qualified farm property and shares of small business corporations;  
(b) the proportion of a gain to be included was increased to three-quarters; the \$1,000 interest and dividend income deduction was eliminated;  
(c) the amount eligible for capital cost allowance with respect to the cost of a passenger vehicle was reduced to \$20,000; and

(continued...)

tax. The amelioration of the reporting requirements and the re-structuring of the anti-avoidance measures also addressed the issues of fairness and reliability.

Finally, the Canadian taxation system lacked competitiveness compared with those of its major trading partners. This inadequacy was accentuated by the U.S. Tax Reform. To address the issue, it was important that Canada lower its tax rates. Of course, lower tax rates warranted a broader tax base to maintain the government's revenues. Contrary to the objectives of fairness and reliability which would be directly served by GAAR, competitiveness would only be served indirectly by protecting the tax base: GAAR would permit the Canadian government to keep low tax rates which would, in turn, foster Canada's international competitiveness. Moreover, as there is certainly no one who considers Canada to be a tax haven, the rule would render more difficult and less attractive complex schemes to divert the income of Canadian taxpayers to the United States, Bermuda, Hong Kong, or other countries having more advantageous tax rates.

## **B. Paving the Way**

A number of factors interacted to pave the way for the Department of Finance to consider new avenues to curb the flourishing of illegitimate tax avoidance schemes and the resulting conundrum. Some of these factors were simply a non-fulfilment of the broad objectives of the Reform, while others were problems specifically engendered by changes of different natures in the tax community. Even though all factors were intertwined, those changes in the tax

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<sup>24</sup>(...continued)

(d) the deduction for business meals was limited to 80%; the employment expense deduction was eliminated.

community were more instrumental in sensitizing the Department of Finance to the need for renewal of its anti-avoidance measures.

Public discontent with Revenue Canada offers a proper starting point to examine the determinants that led to a novel approach to the problem of tax avoidance. Public displeasure with Revenue Canada's collection practices during 1982 and 1983 prompted the establishment of the Conservative Party's Task Force on Revenue Canada which was presided over by Perrin Beatty. The Task Force engaged in nationwide hearings providing a forum for the public to express their concerns and critiques about Revenue Canada's policies. At the close of these sessions, the Conservative Party produced a report,<sup>25</sup> published in April 1984, and which embodied recommendations to upgrade the taxation system.

In September 1984, Canadians elected a Conservative government and Perrin Beatty was appointed as Minister of National Revenue. Under his direction, Canadians observed a change in Revenue Canada's attitude which removed, at least partially, the uncertainty which was still constraining the propagation of illegitimate tax avoidance schemes. The rationalization of such behaviour was attempted.<sup>26</sup> However, regardless of the rationale, the results remained the

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<sup>25</sup> Progressive Conservative Party of Canada, *Report of the Task Force on Revenue Canada* (Ottawa: April 8, 1984).

<sup>26</sup> According to David A. G. Birnie, "Living with GAAR: The Effect on Tax Practice", *1988 Corporate Management Tax Conference Report*, Toronto, C.T.F., 1989, at 5:2, that change reflected the high regard in which Mr. Beatty held the concept of the rule of law. (Unfortunately, Mr. Birnie did not define its interpretation of the "concept of the rule of law"). One could conclude, on the other hand, that Mr. Beatty found himself in a relatively paradoxical position which naturally encouraged him to hold the rule of law in high regard. Indeed, all through the *Report of the Task Force on Revenue Canada*, *ibid.*, the vulnerability of the Canadian taxpayers to an overbearing government was emphasized. Comments such as:

- (a) if the rule of law is to survive, Canadian citizens must understand the laws they are expected to obey;
  - (b) even professionals seem to have difficulties in dealing with the provisions of the Act and such an assertion is confirmed by contradictory interpretations given by the employees of the National Revenue;
  - (c) the National Revenue has changed its relatively courteous attitude toward the taxpayers for an offensive one;
  - (d) we have confidence in the basic honesty and the sense of fair play of the Canadians; and
  - (e) if Canadians are treated with decency and respect, our confidence will be proved justified;
- led to recommendations such as:

(continued...)

same. Revenue Canada adopted a more legalistic approach in interpreting the *Act*. It persisted in such a "*modus operandi*" notwithstanding adverse consequences on the enforcement of compliance. Contrary to their previous practice, Revenue Canada officials began to issue Advanced Tax Rulings despite a lack of business purpose in the transaction submitted for approval, and despite the submission of transactions designed to achieve unauthorized tax avoidance. Furthermore, a Declaration of Taxpayer Rights was released and reproduced at the back of the federal tax guide, enunciating that "[y]ou [the taxpayer] have a right to arrange your affairs in order to pay the minimum tax required by the law" [emphasis added]. Apparently, the words "the minimum tax required by the law" does not convey the same meaning to the taxpayers as it does to Revenue Canada officials. As a result, the taxpayers and their advisers dared to undertake more aggressive tax avoidance strategies.

As previously discussed, the Department of Finance offered another explanation for the ever increasing offensive tax planning. According to the Department, the overwhelming tendency of the public to be involved in tax avoidance schemes was the fruit of the special tax

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<sup>26</sup>(...continued)

- (1) agreement should be reached with the taxpayers before reassessment;
- (2) the solicitor-client privilege should be extended;
- (3) a small claims tax tribunal should be instated;
- (4) the drafting of the *Income Tax Act* should be simplified; and
- (5) a Taxpayer Bill of Rights should be issued and the Advanced Tax Ruling process should be improved.

Allegations that the Department's officials were acting with impunity and little accountability to the taxpayers served as the key argument for the issuance of the Taxpayer Bill of Rights. Complaints regarding the ineffectiveness of the Advanced Tax Ruling process were the rationale for recommending its amelioration. The Task Force suggested that, because the ruling process was one of the most useful services Revenue Canada could offer, the Department should be more open, rarely refuse to rule, do everything in its power to assure that reasonable ruling requests be accepted and should publish the common rulings and the rulings in emerging areas. Really, how could Mr. Beatty ignore such statements?

Interestingly, although this factor seems to be recognized throughout the tax literature - see *e.g.*: D. A. G. Birnie, *ibid.*; Brian J. Arnold & James R. Wilson, "The General Anti-Avoidance Rule - Part I", (1988) 36 Can. Tax J., 829 - it is entirely ignored by the Department of Finance in its Budget Papers.

preferences.<sup>27</sup> "The growth of preferences has undermined public respect for the tax system and has led many Canadians to question its basic fairness. A lack of respect for integrity and fairness of the tax system is a particularly serious problem for Canada, where the tax system rests upon the foundation of self-assessment and voluntary compliance."<sup>28</sup>

It is unlikely that either the presence of tax preferences or the change in Revenue Canada's attitude alone amounted to the sole vindication for the burgeoning pugnacity in tax planning. Nonetheless, the presence of so many tax preferences undeniably rendered tax avoidance easier, thus more attractive. The cumulative effect of tax preferences with relatively high tax rates<sup>29</sup> psychologically disposed taxpayers to avoid taxes and one entered therefrom into a "vicious circle" of avoidance. This "vicious circle" is in reality a simple, yet an inherent component to any taxation system. Its starting point resides in the dislike of taxpayers to paying taxes, though this fact alone does not necessarily lead to tax avoidance.<sup>30</sup> The decision of

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<sup>27</sup> See e.g.: *Income Tax Act*, R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63, and as subsequently amended, paragraphs 20(1)(v.1): resource allowance, 20(1)(ff): payments by farmers, 20(1)(kk): exploration and development grants, 110(1)(b.1): deduction for charitable and similar donations, and sections 113: deduction in respect of dividend received from foreign affiliate, 125: small business deduction and 127.3: scientific research and experimental development tax credit.

<sup>28</sup> *White Paper*, *supra* note 5 at 10. It is acknowledged that the quotation might also apply to the Department's concerns related to tax evasion. Nonetheless, in light of the following quotation, notably by juxtaposing the last sentence of each quotation, the former reveals its concerns with respect to tax avoidance issues. See also: *White Paper*, *ibid.* at 55:

The government is concerned with the accelerating proliferation of tax avoidance schemes. Many opportunities for tax reduction occur as a result of sophisticated tax strategies that often involve the combined or serial application of various technical provisions to yield to unintended tax advantages...The important objective of fairness requires action to curtail the increase in this type of tax avoidance activity.

<sup>29</sup> The prevailing corporate tax rate, in the early 1980's, was 46%. It was reduced to 43% in 1986. It was further reduced, in 1988, with the coming into force of the modifications of the Reform, to 38%. With respect to individuals, the top federal marginal rate, for the years 1982 and subsequent, stood at 34% and was applicable to earners of \$24,000 and over. That rate was already lower than the previous years: for a similar taxable income, a 36% tax rate was levied which would reach 43% for earners of \$60,000 and over.

<sup>30</sup> B. Guy Peters, *The Politics of Taxation: a Comparative Perspective* (Cambridge & Oxford: Blackwell, 1991).

taxpayers to turn to tax avoidance is conditioned by various determinants.<sup>31</sup> These include the perception that the high burden of taxes to which they are subject is not justified by the governmental services received, the perception "that governments are wasteful and inefficient",<sup>32</sup> and the perception that the tax burden is not shared equally because others "cheat" in paying their taxes or take undue advantage of the tax preferences. Moreover, the average taxpayer will weigh the costs and benefits of achieving tax avoidance before engaging upon it.

The aforementioned determinants are closely related to the perception of the equity of the taxation system, which is crucial for compliance:

Citizens may not like to pay taxes, but they may still think that the system is fair and thereby be more unwilling to pay. ...a tax system that appears equitable for citizens is desirable not only for reason of social justice but also for more instrumental reasons of improving tax collection.<sup>33</sup>

The impression of unfairness leads some to tax avoidance and others, who can not avail themselves of the means to avoid, to tax evasion. In other words, uncontrolled tax avoidance leads to the perception that the taxation system is unfair, and this perception of unfairness in the system fosters tax avoidance.

The Canadian taxation system offers an ideal environment for the reinforcement of the above described psychological pattern. It is probably fair to say that Canadians perceive their government as being wasteful and inefficient, and as failing to fulfil their aspirations. At the

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<sup>31</sup> See: B. G. Peters, *ibid.*; John C. Strick, "Critical Limits to Taxation", (1992) 40 Can. Tax J. 1315-1331; Diane K. Wentworth & Annette U. Rickel, "Determinant of Tax Evasion and Compliance", (1985) 3 Behavioral Sciences & the Law 455-466. See also: Neil Brooks & Judy Fudge, *Search and Seizure under the Income Tax Act*, A Study Paper prepared for the Law Reform Commission of Canada (Ottawa: Law Reform Commission, 1985), which discusses the importance of enforcement powers, and the need that they be fair, to ensure compliance.

<sup>32</sup> J. C. Strick, *ibid.* at 1324.

<sup>33</sup> B. G. Peters, *supra* note 30 at 173.



time of the Reform, Canadians felt that their taxes were high and the numerous tax preferences facilitated the achievement of tax avoidance. The change in Revenue Canada's attitude further assisted it. One only had to complete the circle.

The problem of tax avoidance existed because no appropriate method was put forward to thwart it. There was no general statutory limitation on tax avoidance.<sup>34</sup> As a palliative, the Department of Finance enacted a specific anti-avoidance rule to cover each instance where taxpayers availed themselves of tax benefits in a manner disapproved by it.<sup>35</sup> Far from deterring taxpayers from tax avoidance, they, with the help of their tax advisors, built avoidance schemes by reference to them. Specific anti-avoidance rules are, by their nature, not general but detailed. The non-generality of the provisions failed to prevent the creation of additional strategies while their detail accounted for the creation of such strategies. Specific rules set out accurately every one of the elements composing the transactions unauthorized by Revenue Canada. Their ultimate target, thus, was to bar well-defined avoidance schemes from further perpetration, a laudable attempt perhaps, but it engendered other problems. The Department of Finance and Revenue Canada, which were expected, with reason, to state the law, became late-comers in this regard, accomplishing little to improve the undermined respect of the taxation system. By virtue of an intensive usage of specific rules, the Department also created a "road map" revealing the avenues leading to yet unbarred tax avoidance.<sup>36</sup>

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<sup>34</sup> Former subsection 245(1) was limited to deductions in the computation of income that would unduly or artificially reduce income. Therefore, a reduction of the taxable income or of the tax payable would not have been taken into account for tax avoidance purposes. Neither would it have applied if the reduction of income was not undue or artificial, nor if it did not result from a deduction. See: D. D. Dodge, *supra* note 17 at 5-8.

<sup>35</sup> See *e.g.*: *Income Tax Act*, *supra* note 27, sections 67, 187.1, and subsections 55(1), 55(2), 87(4), 95(6), 110.6(8).

<sup>36</sup> Specific rules say that if a taxpayer undertakes steps A, B and C, the transaction will be considered illegitimate. Implicitly, they also mean that if a taxpayer undertakes steps A, C and D, the transaction will not be considered illegitimate. That is how the road map is drawn.

Until 1987, year of the Reform, the Department quite stubbornly regulated tax avoidance through specific provisions. A plethora of rules was introduced, many of them initially through press releases which were followed by legislation months, or even years later. These left the above mentioned problems unsolved.

The scope of judicial limitations was also reduced. Judicial limitations over tax avoidance, compared to those in other countries,<sup>37</sup> were meagre. As discussed in the first chapter, the Canadian courts relied on various doctrines but in an inconsistent manner. None of the doctrines truly prevailed over the others. No true relationship was established between the doctrines: sometimes they were applied independently of one another, sometimes they were mingled together. Moreover, it was uncertain just how aware Canadian courts were of the doctrines and how well they understood them.

By reason of the proliferation and success of unintended tax avoidance strategies, the fairness, reliability and competitiveness of the Canadian taxation system were threatened. The existing statutory measures were inadequate. The existing anti-avoidance doctrines were also inadequate and ill-defined, and were hence subject to any stretch of the judges' imagination. Under these circumstances, who could declare that changes were not warranted?

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<sup>37</sup> The Civil Law jurisdictions, for example France and Belgium, expanded their abuse of rights' doctrine to tax law. The United Kingdom relied mainly on the step transactions doctrine established by a trilogy of the House of Lords in *W. T. Ramsay Ltd. v. C.I.R.*, [1981] 1 All E.R. 865 (H.L.) [hereinafter referred to as *Ramsay*], *C.I.R. v. Burmah Oil Co.*, [1982] S.T.C. 30 (H.L.) [hereinafter referred to as *Burmah Oil*] and *Furniss v. Dawson*, [1984] 1 All E.R. 530 (H.L.) [hereinafter referred to as *Dawson*]. The United States adopted a business purpose test for which the starting point was *Gregory v. Helvering*, 293 U.S. 465 (1935) [hereinafter referred to as *Gregory*]. See also: pp.68-79 below.

### C. Alternatives to the General Anti-Avoidance Rule

The seriousness of the avoidance problem propelled the Department of Finance to revise its methods of dealing with it. The U.S. Tax Reform greatly influenced the timing of the revision. Indeed, it became urgent to prevent successful avoidance strategies in particular those that could have been biased by the United States' taxation structure.

As a first response to the conundrum, the Canadian government joined the universal trend to broaden the tax base and lower the rates.<sup>38</sup> The principal expectation arising from a broader tax base and lower tax rates, however, was not to repress tax avoidance but to balance the aims of fairness and competitiveness. It nevertheless diminished the number of possibilities to achieve tax avoidance and the amount of the benefits that could be contemplated, thus causing tax avoidance to be less alluring.

In addition, the government wanted to indicate clearly to the tax community that it would not remain the latecomer in this action-reaction contest where public welfare was at stake. Indeed, having fed for many years a tax avoidance addiction, the government would have to do better than broaden the tax base and lower the tax rates to bring it to term. There would always be people for whom even a small percentage of savings through tax avoidance represented a huge sum. The alternatives were threefold: the enactment of a myriad of specific anti-avoidance rules, the elaboration of judicial doctrines or the enactment of one general anti-avoidance provision.

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<sup>38</sup> The top Canadian tax rate for individuals was put down to 29% and the corporations' to 38%.

The United States were not the only nation engaged in a reformatory process of its taxation system. So were the United Kingdom, Australia, New Zealand, France, West Germany, Finland, Spain, the Netherlands, Belgium and Japan. However, in light of the particular trading ties between Canada and the U.S., the focus lies on them.

The alternative selected had to serve each of the five broad objectives of the Reform as applied to the unique context of tax avoidance. Simplicity and consistency, however, were not as important as fairness, competitiveness and reliability. The chosen technique had to prevent the erosion of tax revenues through purely tax motivated strategies. It also had to preclude new forms of "tax-avoidance-motivated" transactions from emerging, rather than "filling the gaps" as had been the current practice for the past few years. This practice was perceived as unfair and was not reliable for revenue raising purposes.

#### 1. Statutory Limitations of Tax Avoidance

The past experience with specific anti-avoidance rules confirmed the disadvantages foreseen by the Carter Commission.<sup>39</sup> Those disadvantages are the difficulty of predicting all avoidance schemes and therefore their prevention, the possibility of creating new loopholes and a road map for tax avoiders, the possibility of curbing legitimate transactions and the accounting of those rules for the complexity of the *Act*.

Moreover, specific rules simply do not meet the level of adequacy necessary to fulfil the Reform's objectives. As discussed earlier, since this technique is reactive, it neither prevents the erosion of the tax base, nor preserves public respect for the taxation system, the latter being critical to the perception of fairness in the system which underlies the principle of self-compliance.<sup>40</sup> Furthermore, the reform of the tax base and rates was based on the assumption

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<sup>39</sup> Canada, *Report of the Royal Commission on Taxation*, vol.3 (Ottawa: Queen's Printer, 1966).

<sup>40</sup> David D. Dodge, "Tax Reform and Anti-Avoidance Proposals", *1987 British Columbia Tax Conference*, Toronto, C.T.F., 1988, Tab 4, at 3-4:

...I do not believe that [the resulting] complex and detailed provisions would be seen by anyone as an improvement. With increasing detail, flexibility is lost and legitimate  
(continued...)

that the government's intent in the taxing provisions would be respected and, accordingly reliable revenues would be derived from the broader base to in compensate for the losses generated by the lowering of the tax rates. Specific rules did not offer this reliability. Loopholes had to be constantly patched to ensure respect for the government's intent.

One general rule can offer more fairness, reliability and simplicity to the taxation system, as it offers the possibility to be up-front with tax avoidance schemes and to prevent their creation. It also prevents the creation of a road map for tax avoiders.

If carefully designed, general anti-avoidance rules can be powerful weapons against tax avoidance. Brian J. Arnold and James R. Wilson advocate ten "principles to be followed in formulating a statutory general anti-avoidance rule."<sup>41</sup> In my view, the most important of these principles are the following:

- (a) a statutory general anti-avoidance rule should be broad enough to deal with all types of transactions that result in abusive tax avoidance;
- (b) a general anti-avoidance rule must distinguished between abusive tax avoidance transactions and legitimate tax avoidance transactions;
- (c) any general anti-avoidance rule should be consistent with other anti-avoidance rules;
- (d) only in certain circumstances should a general anti-avoidance rule prevail over other specific statutory provisions;

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<sup>40</sup>(...continued)

transactions are sometimes affected. This is often to the detriment of the uninformed, and certainly to the detriment of the fisc in dealing with he well-advised. Moreover, we believe that such a system undermines taxpayer morale. Because the system is reactive, the early participants, in a technically proper avoidance scheme are the ones most likely to succeed. If taxpayers perceive that access to such schemes is unequal, their sense that the system is fair and that all pay their share may be undermined with adverse effects on compliance.

See also: *supra* notes 30 and 31, and accompanying text.

<sup>41</sup> "The General Anti-Avoidance Rule - Part 2", (1988) 36 Can. Tax J. 1123-1185, at 1142.

- (e) a general anti-avoidance rule should minimize uncertainty for taxpayers;
- (f) a general anti-avoidance rule should apply as a provision of last resort;
- (g) the taxpayers must be entitled to appeal all aspects of the application of a general anti-avoidance rule; and
- (h) the determination of the tax consequences of a transaction to which the general anti-avoidance rule applies should be appropriate for the particular transaction.<sup>42</sup>

Notions of breadth and certainty are central to the formulation of a politically agreeable rule, but are also closely related to their counterparts "overbreadth" and vagueness (or uncertainty). Breadth yields flexibility, which itself may engender uncertainty. In this singular context of the creation and elaboration of a general anti-avoidance rule, the rule should be broad enough to deal with all types of transactions, but not so broad as to catch legitimate tax avoidance transactions. Consequently, such a rule must provide guidance for a distinction between legitimate and illegitimate avoidance transactions. This thin line must be capable of adaptation to various situations, since identical transactions transpiring from different factual settings may warrant opposite conclusions.

The key criteria of an effective general anti-avoidance rule, breadth and flexibility, cast uncertainty into the taxation system. It is this uncertainty, certainty being the "enfant cheri" of tax planners, that has caused, in major part, the objections to GAAR. Nonetheless, uncertainty is also a means for the government to curb tax avoidance activities since people are deterred from engaging on an uncertain route. On the other hand, the uncertainty cannot be of such a magnitude so as to contribute to the mutation from "flexibility" into "uncontrolled administrative

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<sup>42</sup> *Ibid.* at 1142ff. The two other principles advocated by Messrs. Arnold and Wilson are: (1) a general anti-avoidance rule should focus on the results of a transactions rather than the taxpayer's purpose, and (2) it should impose a penalty for tax avoidance.

discretion", and thereby jeopardizing the survival of a general rule to a constitutional challenge.<sup>43</sup>

## 2. Judicial Limitations of Tax Avoidance

In the best of all worlds, I believe that anti-avoidance measures would be of a judicial nature. Judicial anti-avoidance measures allow for the breadth and flexibility of a general rule without its overbreadth. It is the very essence of judge-made law to expand upon the facts of a case to create principles of law rather than to apply principles to the facts. In the ever changing discipline that is taxation, this characteristic of the judge-made law allows anti-avoidance measures to be flexible. Since the principles are expanded upon, and assessed against, the facts of each case, it saves them from the danger of overbreadth and allows for readjustments in objectives. Until such judicial anti-avoidance measures attain full maturity, principles remain, however, highly uncertain in their application. They have, nonetheless, the advantage that the meaning of a judge-made law can always be traced back to the facts of a case, and the courts

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<sup>43</sup> The preponderance of the objections to GAAR were the product of the sentiment that a veil of uncertainty, or of vagueness, was clothing the rule. It was however specified that uncertainty in the rule is not necessary a consequence of the breadth of the rule, although it can be; uncertainty exist in itself. In this regard see: Joel A. Nitikman, "Is GAAR Void for Vagueness?", (1989) 37 Can. Tax J. 1409-1447, at 1424. The vast majority of the objections to GAAR were related to its contended infringement of the rule of law. The rule of law is said to be composed of two branches which are requirement that one must be protected from arbitrary judgments and that one must be subject only to rules which are known by their subjects. See: J. A. Nitikman, *ibid.* at 1419 and 1426 respectively:

A law is defined as being too vague when, after applying all known rules of statutory interpretation, it is not possible to say what Parliament has prescribed or proscribed.

There are two branches of the rule of law: first that the law is supreme even over the government and thereby preclusive of arbitrary power; and second, that there must be an order of positive laws, that is, of subjection only to known legal rules.

See also: H. J. Kellough, *supra* note 3 at 61, quoting Harry Street and Rodney Brazier, eds., *Constitutional and Administrative Law, de Smith*, 4th ed. (Harmondsworth, Eng.: Penguin Books, 1981).

can always give some clue as to where the principle elaborated on the facts of one case could lead in order to limit the uncertainty related to future courts' decisions.

Unfortunately, we do not live in the best of all worlds. It has been very difficult for Canadian courts to develop consistent, logical and prudent anti-avoidance doctrines. Tax avoidance cases seemed to have engendered more instinctive decisions than unbiased analysis. Therefore, in the above reasoning, inconsistency and chaos take over flexibility. Overbreadth becomes familiar and uncertainty is multiplied.

Furthermore, at the end of the day, one question remains: is it the proper role of the courts to determine the extent to which the national revenues should be protected?

### 3. Experience of Others

This tax avoidance madness is not particular to Canada. Around the world, taxpayers and tax practitioners take pride in embarking upon the lucrative business. A study of what has been done by foreign governments and courts to deal with this problem illustrates the options that were available to the Canadian government.

#### a) Civil Law Jurisdictions

Jurisdictions which have their legal systems based upon the civil law<sup>44</sup> usually recognize in their private law the doctrine of abuse of rights and have little difficulty in adapting it to their taxing statutes. The doctrine of abuse of rights is concerned with the exercise of rights for an

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<sup>44</sup> For example France, Germany, Belgium, Switzerland, Japan and Sweden.



improper purpose. In private law, the typical improper purpose is the causing of harm to another. The doctrine "may also be understood as applying more widely so as to cover cases in which a person seeks to use legal form or procedure for the purpose of avoiding certain consequences that the law would otherwise attach to his activities".<sup>45</sup>

The doctrine has its origins in Roman law. Albeit Romans' fundamental conception of a right was that it should be absolute -- *neminem lardit qui suo jure utilis* (one who uses of his rights can do no wrong) -- a few maxims attenuated this conception and served as foundations to the doctrine: *male enim nostro jure utinem debemus* (one must not make unjust use of his right) and *malitus non est indulgendum* (there is no indulgence for villainies). Similarly, in civil law jurisdictions, where rights enunciated in the civil codes are declared in absolute terms, these rights need to be judicially interpreted to reveal their implications in particular cases. In such cases, the doctrine of abuse of rights is used to qualify those absolute rights.<sup>46</sup> While in some jurisdictions, the doctrine has been implemented through judicial and doctrinal work,<sup>47</sup> in others, it has been implemented through legislative provisions either in a civil code<sup>48</sup> or in the Constitution.<sup>49</sup>

For English courts, however, the doctrine seemed confusing. "How can it be meaningful to say that an act that abuses a legal right is unlawful? Either one has a right to do an act or one does not, and to speak of an act that is an unlawful exercise of a legal right to do the act

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<sup>45</sup> David A. Ward & Maurice C. Cullity, "Abuse of Rights and the Business Purpose Test as Applied to Taxing Statutes", 29 Can. Tax J. (1981) 451-475, at 451.

<sup>46</sup> *Brodeur v. Choinière*, [1945] Qué.S.C. 334.

<sup>47</sup> For example France and Belgium.

<sup>48</sup> For example Germany and Switzerland.

<sup>49</sup> For example Japan.

seems to be self-contradictory non-sense."<sup>50</sup> Accordingly, the English courts denied that the doctrine had any application to the English law and Commonwealth courts agreed.<sup>51</sup> David Ward suggests that the different approaches to the law adopted by civil law and common law courts explain those two different conceptions of the doctrine:

[i]t is suggested that the divergence of the common law in this important respect [refusing to develop the doctrine of abuse of rights] arises because when, as in the continental systems, legal rights are codified and declared in absolute terms, it is inevitable that the courts will place some reasonable limitation upon the exercise of such rights. On the contrary, in common law jurisdictions, rights were not usually defined in absolute terms by the courts but evolved on a case by case basis and usually without regard to any motivation or purpose of the person whose actions were challenged. In consequence, the courts were rarely confronted with the necessity of placing limitations on rights that had been previously declared in absolute terms. The issue became one of defining in each case the extent of a person's right to do a particular thing.<sup>52</sup>

When applied to taxation law, the main effect of the doctrine is to limit the taxpayer's ability to use legal forms and technical provisions so as to attract as little tax as possible with no other purpose than the reduction of taxes:

... the doctrine stipulates that it is an abuse of the taxpayer's rights, or an abuse of the private law itself, to attempt to use legal forms and institutions solely for the purpose of reducing taxes otherwise payable, where such an abuse is shown, the court will nullify the hoped for tax advantage.<sup>53</sup>

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<sup>50</sup> D. A. Ward & M. C. Cullity, *supra* note 45 at 453.

<sup>51</sup> *Bradford (Mayor) v. Pickles*, [1895] A.C. 587 (H.L.); *Allen v. Flood*, [1898] A.C. 1 (H.L.); *Salomon v. Salomon & Co.*, *Salomon & Co. v. Salomon*, [1897] A.C. 22 (H.L.).

<sup>52</sup> David A. Ward, "Tax Avoidance: Judicial and Legislative Approaches in Other Jurisdictions", *Report of the Proceedings of the Thirty-Ninth Tax Conference* (1987 Conference Report), Toronto, C.T.F., 1988, 8:1-53, at 8:27.

<sup>53</sup> D. A. Ward & M. C. Cullity, *supra* note 45 at 452.

Traditionally, the application of the doctrine to taxation law was rejected in Belgium. More recently, however, it seems that the courts have applied it, "but without the label".<sup>54</sup> In France, the courts had no problem in adapting the doctrine to fiscal matters. Interestingly, the Revenue bears the burden of proof when it seeks the application of the doctrine.<sup>55</sup> Like many other civil law jurisdictions which recognize the abuse of rights doctrine, Switzerland and Germany also apply it to taxation matters. Moreover, through the Decree of the Federal Council Concerning Measures Against the Improper Use of Conventions Concluded by the Confederation for the Avoidance of Double Taxation,<sup>56</sup> not only does Switzerland apply the doctrine to its domestic law, but also applies it to its treaties. Germany has embodied the doctrine in its General Tax Code.<sup>57</sup>

b) United Kingdom

As mentioned above, the English courts clearly rejected the abuse of rights doctrine. For a long time, in the United Kingdom, the *Duke of Westminster* principle determined the attitude the courts should have toward tax avoidance. Peter Millett suggests that the case has been wrongfully interpreted:

*I.R.C. v. Duke of Westminster* gave rise to two allied and dangerous myths: (i) that in tax cases, to an extent unknown in other areas of law,

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<sup>54</sup> D. A. Ward, *supra* note 52 at 8:35.

<sup>55</sup> *Ibid.* at 8:38.

<sup>56</sup> R.O. 1962, p. 1680.

<sup>57</sup> Paragraph 42 Abgabenordnung, 1977.

form prevails over substance; and (ii) that the substance of a transaction, and the only thing to be regarded, is its legal effect.<sup>58</sup>

I agree with Millett's suggestion. Nonetheless, it was up to the courts and Parliament to react to such results.

This situation lasted for almost 50 years before the *Duke of Westminster* principle was redefined in *Ramsay*.<sup>59</sup> Prior to *Ramsay*, tax consequences were determined based upon the strict rights and obligations of the transactions. If a transaction had multiple steps, each step would be examined independently. "The taxpayer was not taxed by reference to what he did, but by what he contracted to do."<sup>60</sup> However, during World War II and for a long period thereafter, the United Kingdom was subject to high taxation rates and inflation.<sup>61</sup> Tax avoidance became big business. "Tax avoidance packages" were commercially marketed. The government replied with specific anti-avoidance rules but never enacted a general one. While Inland Revenue and tax advisers played an intellectual chess game, the technicality and artificiality of the schemes continued to escalate and so did the public outcry. In light of the circumstances, the courts concluded that they ought to do consider the *Duke of Westminster* principle in a more comprehensive manner.

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<sup>58</sup> Peter Millett Q.C., "Artificial Tax Avoidance: The English and American Approach", 1986 B.T.R. 327-339, at 334.

<sup>59</sup> *Ramsay*, *supra* note 37 at 871:

They [the commissioners] are not, under the *Duke of Westminster* doctrine or any other authority, bound to consider individually each separate step in a composite transaction intended to be carried through as a whole.

<sup>60</sup> P. Millett Q.C., *supra* note 58 at 334.

<sup>61</sup> In 1973-1974, the collapse of the real estate market took everyone by surprise. No one had time to do any tax planning: the money made was subsequently lost and tax bills could not be met. As a result, people were desperate to avoid taxes.

Although only three leading cases are recognized as having revolutionized the English judicial approach to tax avoidance,<sup>62</sup> previous cases had set the foundations for such decisions.<sup>63</sup> *Ramsay*, *Burmah Oil* and *Dawson* elaborate what is known as the step transactions doctrine. *Ramsay* was the first case of the trilogy. In his judgment, before elaborating on the step transactions doctrine, Lord Wilberforce reviews some of the taxation principles which, I think, are important to understand the beauty of his reasoning:

1. A subject is only to be taxed on clear words, not on "intendment" or on the "equity" of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle. What are "clear words" is to be ascertained on normal principles; these do not confine the courts to literal interpretation. 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.

2. A subject is entitled to arrange his affairs so as to reduce his liability to tax. The fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides. It must be considered according to its legal effect. ...

4. Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. ... This is a cardinal principle but it must not be overstated or over-extended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transactions to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of

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<sup>62</sup> *Ramsay*, *supra* note 37; *Burmah Oil*, *supra* note 37; *Dawson*, *supra* note 37.

<sup>63</sup> *Nominees v. Nicols*, [1975] S.T.C. 372 (Ch.) *per* Templeman J.; *Ransom v. Higgs*, [1974] S.T.C. 539 (H.L.) *per* Lord Wilberforce; *Floor v. Davis*, [1978] Ch. 295 (C.A.) *per* Eveleigh L.J. *rev'd*, but on grounds different from those of Eveleigh L.J., [1979] 2 All E.R. 677 (H.L.); and *Chinn v. Hochstrasser*, sub. nom. *Chinn v. Collins*, [1981] 1 All E.R. 189 (H.L.) *per* Lord Wilberforce.

transactions, intended to operate as such, it is that series or combination which may be regarded.<sup>64</sup>

Accordingly, when the courts are faced with:

(a) a preordained series of transactions, and

(b) inserted steps that have no commercial or business purpose apart from tax avoidance, the series of transactions will be viewed as one single composite transaction.<sup>65</sup>

*Ramsay*, *Burmah Oil* and *Dawson*, do not affect the principle that taxpayers must be taxed by reference to what they have done and not by reference to what they might have done. Rather they modify the traditional approach to a transaction. Traditionally, to qualify what the taxpayer had done, the court would look at each step of a transaction individually. *Ramsay*, *Burmah Oil* and *Dawson* reject that approach in favour of a test whereby a transaction composed of a series of preordained steps may be viewed as a whole.<sup>66</sup> Whether the taxpayer entered into a single composite transaction, or a series of independent transactions, is a question of fact. Furthermore, "in a preplanned tax saving scheme, no distinction is to be drawn for fiscal purposes, because none exists in reality, between (i) a series of steps which are followed through by virtue of an arrangement which falls short of a binding contract, and (ii) a like series of steps which are followed through because the participants are contractually bound to take each step *seriatim*. ... *Ramsay* says that this fiscal result cannot be avoided because the preordained series

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<sup>64</sup> *Ramsay*, *supra* note 37 at 870, 871.

<sup>65</sup> *Ramsay*, *ibid.*; *Burmah Oil*, *supra* note 37; *Dawson*, *supra* note 37 at 543:  
The formulation by Lord Diplock in *Burmah Oil* expresses the limitations of the *Ramsay* principle. First, there must be a preordained 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. ... Second, 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.

<sup>66</sup> *Ibid.*

of steps is to be found in an informal arrangement instead of in a binding contract. The day is not saved for the taxpayer because the arrangement is unsigned or contains the magic words 'this is not a binding contract'.<sup>67</sup>

Once the court has determined that the facts of the case reveal one single composite transaction, it is a matter of statutory construction to determine the tax implications of the transaction.<sup>68</sup> It should also be stressed that what is critical to the application of the doctrine is not the presence of a tax avoidance motive, but the absence of any purpose other than the avoidance of taxes. Finally, the burden falls on the Commissioners to prove the facts that establish that the two requirements of the doctrine have been met.<sup>69</sup>

c) United States of America

As a means to deal with tax avoidance, the U.S. courts principally have developed the business purpose test and step transactions doctrines. As with the step transactions doctrine in the United Kingdom, these American doctrines have developed judicially. The United States taxing statute also contains no general provision limiting the avoidance of taxes.

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<sup>67</sup> *Dawson, supra* note 37 at 542, 543.

<sup>68</sup> *Ibid.* at 543.

<sup>69</sup> *Ibid.* at 543:

The formulation therefore involves two findings of fact: first whether there was a preordained series of transactions, i.e. a single composite transaction; second, whether that transaction contained steps which were inserted without any commercial or business purpose apart from a tax advantage. Those facts are to be found by the commissioners. They may be primary facts or, more probably, inferences to be drawn from the primary facts. If they are inferences, they are nevertheless facts to be found by the commissioners.

The U.S. doctrines have been developed around *Gregory v. Helvering*.<sup>70</sup> In that case, Mrs. Gregory wanted to extract assets from her wholly owned corporation, but did not wish that extraction to be taxed at ordinary rates. Instead, she entered into a tax scheme composed of a series of transactions which would allow her to report the transaction as a capital gain and, be therefore subject to lower tax rates. The Court's decision in *Gregory* gave rise to the above two doctrines and to their circumvolved application. Indeed, in *Gregory*, the U.S. Supreme Court regards the absence of a business purpose as a key factor in determining whether or not a single transaction is in fact part of a series of transactions; however, when faced with a series of transactions, the courts review more carefully the presence or absence of a business purpose. What came first, the chicken or the egg? Nevertheless, it seems that their application should be consequential: first, business purpose test and second, step transactions doctrine. As David Timbrell points out, "[t]he chain of logic thus runs as follows:

- 1) The absence of business purpose for a particular transaction allows it to be seen as part of a series of transactions.
- 2) When a series of transactions is observed, their form and their substance is their aggregate result, taken from the beginning to the end of the series.
- 3) Taxation should be imposed on the basis that the real transaction is that which directly, rather than indirectly, achieves the aggregate result."<sup>71</sup>

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<sup>70</sup> *Supra* note 37.

<sup>71</sup> David Y. Timbrell, "Planning after the *Stuart* Decision: the Business Purpose Test", *Report of the Proceeding of the Thirty-Sixth Tax Conference* (1984 Conference Report), Toronto, C.T.F., 1985, 89-105, at 92.



*Gregory* does not substantiate a strict business purpose test. The absence of a business purpose to a transaction does not automatically lead to its negation for tax purposes. It only leads to its negation when:

- (a) the presence of a business purpose is mandated by the statute's intent; and
- (b) the absence of such purpose convinces the courts that the whole transaction is nothing more than series of transactions.

Ruling otherwise would negate the legislator's intent. Indeed, if the legislator enacts tax incentives, the transactions benefiting from this incentive will not be ignored for tax purposes even if they have no other purpose than the mitigating of one's tax liability.<sup>72</sup> "To put it another way, the test is whether a reasonable legislator would have expected the tax benefit in question to be utilized as the taxpayer has done had the legislator considered the question at the time of enactment."<sup>73</sup>

The business purpose doctrine derived from *Gregory* is most developed in cases involving corporate reorganizations. The courts seem reluctant to adopt it as a rule of general application.<sup>74</sup>

The step transactions doctrine has three different formulations: binding commitment, interdependence and end result tests. Under the "binding commitment test", the courts integrate the steps of a transaction if the parties are contractually bound to take the further steps once the

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<sup>72</sup> *Estate of Jerry Thomas*, 84 T.C. 412 (1985); *Rice's Toyota World Inc. v. Commissioner*, 81 T.C. 184 (1983), aff'd in part and rev'd in part in 752 F.2d 89 (4th Cir. 1985).

<sup>73</sup> Kenneth W. Gideon & Ruth E. Kent, "Mrs. Gregory Northern Tour: Canadian Proposals to Adopt the Business Purpose Rule and the Step Transaction Doctrine", *Report of Proceedings of the Thirty-Ninth Tax Conference* (1987 Conference Report), Toronto, C.T.F., 1988, 7:1-14, at 7:4.

<sup>74</sup> *Smith et al. v. C.I.R.*, 78 T.C. 350 (1982).

first step has been completed, and tax liability is assessed based on the integrated steps.<sup>75</sup> Under the "interdependence test", the different steps of a transaction are so interrelated that it would be pointless not to complete the other steps once the first one as been completed.<sup>76</sup> Accordingly, the courts integrate each of the steps of the transaction before assessing the tax liability. Finally, under the "end result test", the courts integrate the steps of a transaction when it appears that end result was intended from the outset and that steps were undertaken in order to reach this end result.<sup>77</sup>

The acceptable length of time allowed between each step for it to be part of the same composite transaction seems to relate to the criterion that if the first transaction sets up the opportunity for another step and tax avoidance is the result, the two steps will be linked to one another regardless of the time spacing them.<sup>78</sup>

#### d) Australia and New Zealand

In Australia, the taxing statutes have contained general anti-avoidance provisions since 1877. In 1936, section 260 of the *Income Tax Assessment Act*<sup>79</sup> was enacted. Its effect was

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<sup>75</sup> *Commissioner v. Gordon*, 391 U.S. 83 (1968).

<sup>76</sup> K. W. Gideon & R. E. Kent, *supra* note 73 at 7:6; Vern Krishna, *Tax Avoidance: The General Anti-Avoidance Rule* (Toronto: Carswell, 1990) at 73.

<sup>77</sup> *King Enterprises Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

<sup>78</sup> *Bazley v. C.I.R.* 331 U.S. 737 (1947).

<sup>79</sup> 1936 (Cth) [hereinafter referred to as *Assessment Act*].

to void any contract, agreement or arrangement entered into for the purpose of avoiding taxes, but it was rendered quasi ineffective by court interpretation.<sup>80</sup>

With that, the tax avoidance industry grew. Consequently, in 1981, the legislature replaced section 260 with a much broader provision: part IVA of the *Assessment Act*. The new enactment and strong administrative measures have resulted in reduced tax avoidance activities.<sup>81</sup> Early in the century, New Zealand also enacted a general anti-avoidance rule similar to the Australian section 260.<sup>82</sup> Although New Zealand courts have been more zealous in applying and enforcing the legislative provision, they have not, as have Australian courts, taken on the task of elaborating judicial doctrines to address tax avoidance issues.

#### **D. GAAR: the Outcome**

After considering all alternatives, the Department of Finance opted for the enactment of a general provision.<sup>83</sup> GAAR has been highly criticized. Among other critiques, it has been alleged that:

- (a) a general provision to deal with tax avoidance was unwarranted since judicial doctrines already existed;
- (b) GAAR introduced into the Canadian taxation system a concept similar to the abuse of rights doctrine in civil law, a doctrine that is foreign to our taxation system and therefore as such should be banned; and

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<sup>80</sup> *Cridland v. Commissioner of Taxation (CTH)*, [1978] 52 A.L.J.R. 96.

<sup>81</sup> D. A. Ward, *supra* note 52 at 8:5, 8:6.

<sup>82</sup> *Ibid.*

<sup>83</sup> The full text of GAAR is reproduced in Appendix One of this thesis.

(c) GAAR introduced uncertainty in the Canadian taxation system to an extent that may well be against the rule of law.<sup>84</sup>

It is not within the scope of this thesis to single out and address every critique that has assailed GAAR. This exercise might have been appropriate in the early days of GAAR, but since most of the critiques are either speculative or related to technicalities, or both, I believe that such an exercise would be useless at this point in time.

After seven years of existence, GAAR remains a part of our taxation law. However, as there is always room for improvement, I believe that Messrs. Arnold and Wilson's principles of drafting a statutory general anti-avoidance provision<sup>85</sup> and the above critiques provide a good background for a summary evaluation of GAAR. On its face, GAAR fits within most of the principles enunciated by Messrs. Arnold and Wilson.<sup>86</sup> First, GAAR certainly is broad enough to deal with all types of transactions that result in abusive tax avoidance as subsection 245 (3) treats any transaction resulting in a tax benefit as being a potential tax avoidance transaction;<sup>87</sup> and for this purpose, tax benefit is defined in subsection 245 (1) as being any reduction or increase of an amount, payable or receivable respectively, under the *Act*.

Secondly, through subsections 245 (3) and (4), GAAR establishes the government's distinction between abusive and legitimate tax avoidance transactions.<sup>88</sup> The mere fact that

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<sup>84</sup> See: *supra* note 1, groups objecting to GAAR; H. J. Kellough, *supra* note 3; D. C. Nathanson, *supra* note 3; J. A. Nitikman, *supra* note 43.

<sup>85</sup> *Supra* note 42 and accompanying text.

<sup>86</sup> *Ibid.* Although this chapter is concerned with the *a priori* GAAR's respect of the principles, the deeper issue of whether or not GAAR does in fact respect them, or, at least, as such potential, is a question left open for discussion in chapter three.

<sup>87</sup> *Ibid.*, principle (a).

<sup>88</sup> *Ibid.*, principle (b).

some people do not agree with the distinction made -- some people go even as far as saying that there is no such thing as abusive tax avoidance transactions<sup>89</sup> -- does not preclude GAAR from conforming with the principles of legislative drafting.

Thirdly, subsections 245 (2) and (5) provide that "the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit ..." These provisions limit the reassessment of taxpayers to the facts of the particular transaction and to the denial of the tax benefit. I am therefore satisfied that they are consistent with the principle that the tax consequences of a transaction should be appropriate for it.<sup>90</sup> I am also satisfied that GAAR entitles the taxpayers to appeal all aspects of its application.<sup>91</sup>

Finally, it is unclear whether the interplay of GAAR with the other provisions of the *Act* respects guidelines (c), (d) and (f) of Messrs. Arnold and Wilson.<sup>92</sup>

Outside the realm of drafting principles, a few authors contend that a general provision to deal with tax avoidance was unwarranted and should simply not have been drafted because judicial doctrines already existed in this regard. If the Minister of Finance wished to see the judicial doctrines develop and expand, he should have repealed the only limitation to their growth, former section 245.<sup>93</sup> Had the courts been willing to censure rampant tax avoidance unequivocally, there might have been some basis for this argument. With all due respect, the

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<sup>89</sup> Telephone interview with Joel A. Nitikman, *Fraser & Beatty, Barristers & Solicitors* (July 1995) Vancouver; Telephone interview with William A. Ruskin, *Clark Wilson, Barristers & Solicitors* (July 1995) Vancouver.

<sup>90</sup> B. J. Arnold & J. R. Wilson, *supra* note 42, principle (h).

<sup>91</sup> *Ibid.*, principle (g).

<sup>92</sup> *Ibid.* See also: pp.107-112 below.

<sup>93</sup> H. J. Kellough, *supra* note 3.

study of the judicial doctrines in the previous chapter has demonstrated that Canadian judicial doctrines were little more than a series of inconsistencies.

Naturally, the experiences of the United States of America and United Kingdom could be cited as examples. But what examples really? Certainly, the example set by the United Kingdom is less confused and confusing than the example set by the United States. For instance, while Vern Krishna interprets *Gregory* as being the American approach to the step transactions doctrine,<sup>94</sup> Messrs. Gideon and Kent interpret it as being the American approach to the business purpose test doctrine;<sup>95</sup> David Timbrell interprets it, rightly I believe, as being the American approach to a combination of the business purpose test and step transactions doctrines;<sup>96</sup> and Estey J., in *Stuart* relates it to the sham transactions doctrine.<sup>97</sup> This amounts to a perfect score: four different people having four different opinions about one case. It perfectly illustrates Peter Millett's statement that "a case is not important for what it decides, but for what it is believed to have decided: the myth is the message."<sup>98</sup>

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<sup>94</sup> *Supra* note 76.

<sup>95</sup> *Supra* note 73.

<sup>96</sup> *Supra* note 71.

<sup>97</sup> *Stuart Investments Ltd. v. M.N.R.*, [1984] 1 S.C.R. 536, [1984] C.T.C. 294, 84 D.T.C. 6305, a.

<sup>98</sup> *Supra* note 58 at 333.

It is also very doubtful that Canadian courts would have been as eager as the English courts to address tax avoidance issues. Lord Wilberforce in *Ramsay* makes it rather clear that English courts should not be passive spectators of the game of tax avoidance. So clear that Lord Wilberforce, judge of the United Kingdom which had rejected the application of the abuse of rights doctrine, relied in *Ramsay* on the notion of prejudice to other taxpayers.

I have a full respect for the principles [Parliament should lay down the tax avoidance principles] which have been stated but I do not consider that they should exclude the approach for which the Crown contends. That does not introduce a new principle: it would be to apply to new and sophisticated legal devices the undoubted power and duty of the courts to determine their nature in law and to relate them to existing legislation. While 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) 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.<sup>99</sup>

Estey J., in *Stubart*, is not as keen to protect the taxpayers from one another, although he recognizes that the "object and spirit" of the statute should be respected. Moreover, the case law that followed *Stubart* did not allow the Minister to be overly optimistic with respect to the courts' attitude toward tax avoidance.<sup>100</sup> The case law reinforced the idea that courts should stay clear of policy decisions relating to the avoidance of taxes. Also reinforced, was the view that taxpayers can use a multitude of artifices in order to avail themselves of the benefits of tax

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<sup>99</sup> *Ramsay*, *supra* note 37 at 873.

<sup>100</sup> See e.g.: *Indalex Ltd. v. M.N.R.*, [1986] 2 C.T.C. 482, 86 D.T.C. 6039 (F.C.T.D.); *Irving Oil Ltd. v. M.N.R.*, [1988] 1 C.T.C. 263, 88 D.T.C. 6138 (F.C.T.D.).

provisions before their actions become outrageous. Faced with these facts, I do not know how that first critique can stand.

Other authors contend that GAAR introduces to the Canadian taxation system a concept similar to the concept of abuse of rights which is foreign to our taxation system and as such should be banned.<sup>101</sup> I have a hard time refraining a smile when I read this argument. It is so childish and, at the same time, so typically human: anything that affects one's own secure routine shall not come forward even if it means progress. Racist people put forward the exact same kind of argument:

- (a) that person is black;
- (b) black people are foreign to me, a white person; therefore,
- (c) black people should be banned from America or, at the very least, should be granted an inferior status.

In addition to its irrationality, the argument runs afoul of the theory of the evolution of the legal models.<sup>102</sup> This theory is that, by reason of our awareness of the existence of numerous legal models, we tend to appropriate to ourselves, and integrate into our legal system, those practices belonging to foreign legal models if and when they benefit our system. This theory explains the convergence, in Canada, of the traditions of civil and common law. Indeed, in Quebec since the Conquest, the tradition of civil law has, to a great extent, adopted the theory of the binding precedent known to the common law tradition. To the contrary, the reliance on the legislator to state the law has also tremendously increased since the Conquest in Canadian

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<sup>101</sup> H. J. Kellough, *supra* note 3.

<sup>102</sup> R. Sacco, "La Circulation des Modèles Juridiques", in *International Academy of Comparative Law, General Reports*, XIIIe International Congress (Montréal: Yvon Blais, 1990).



common law jurisdictions. Their next step may well be to adopt general statutory provisions when the context yields itself to it.

Finally, the most legitimate critics contend that GAAR introduces uncertainty in the Canadian taxation system. This is also contrary to Messrs. Arnold and Wilson principle that a general anti-avoidance rule should minimize uncertainty for taxpayers.<sup>103</sup> Some go even as far as alleging that the uncertainty was such that it may violate the rule of law.<sup>104</sup> Such contention, however, has yet to be proved before a court of law. No one would deny that the rule has introduced uncertainty. In fact, that is the precise intention of the government. Some tax avoidance schemes were so abusive, and the problem of tax avoidance had become so substantial, that the government wanted its general anti-avoidance rule to carry a message of a "do it if you dare" game, hoping that as few people as possible would dare to do it. Uncertainty in the rule permits it, and is necessary, to carry such a message. In this regard, the government would probably defend itself by alleging that it minimized the uncertainty of GAAR as much as it could without risking a negation of its purposes.

Accordingly, from a practical point of view, this uncertainty is necessary. An English proverb states: "necessity is the mother of invention." With respect to the invention of GAAR, necessities were to protect the tax base, government's revenues and the fairness of the taxation system; in a word, it was necessary to protect the tax legislation from being misused or abused.

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<sup>103</sup> *Supra* note 42, principle (e).

<sup>104</sup> See *e.g.*: J. A. Nitikman, *supra* note 43. Sometimes, the critique is worded according to another perspective. One can either speak of the uncertainty created by the provision, or of the vagueness of the rule.

For that, as Stanley H. Hartt, formerly Deputy Minister of Finance, wrote, there was only one way: create uncertainty:

There are a number of basic principles and rules on how policy makers should conduct themselves in the elaboration of policy, which are found in the very concept of fairness.

First of all, all practitioners and their clients or principals are entitled to know the law.

The second principle is that the tax laws influence taxpayer behaviour.

The third principles is that, if changes occur, they should be eased.

... my remarks so far invite the question, "If you believe what you just said, how can you explain that on your watch in Ottawa the general anti-avoidance rule (GAAR) was proposed and adopted?" I know that one man's brilliant tax planning is another, perhaps lesser, man's abuse. However, I believe that there is such a thing as a borderline between planning and abuse. It may be indefinable, just as the body of administrative practices and rules constituting what I have called the "state of art" or "conventional wisdom" is indefinable, but I believe it exists.

... There is the state of art, and there is a difference between creativity and pushing it.

The principles I have enunciated are not unilateral. If practitioners want policy makers to be forthright, clear, and unambiguous and not play "gotcha," to understand the economics consequences of changes, and to introduce so-called improvements in a fair and democratic way, they themselves must act reasonably and in good faith. If people want to understand the origins of GAAR, all they need is open their old files and look back to the transactions that were on the street at that time.

... I think that pushing it and straining credulity is what led to GAAR.<sup>105</sup>

We cannot have it all, can we?

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<sup>105</sup> Stanley H. Hartt, "Making Policy in the Light of the Day", *1992 Corporate Management Tax Conference Report*, Toronto, C.T.F., 1993, 13:1-5, at 13:1-3.

### CHAPTER THREE. DOCTRINAL LAW RELATED TO THE GENERAL ANTI-AVOIDANCE RULE

In the seven years of GAAR's existence, it has been the object of only one judicial decision.<sup>1</sup> Accordingly, technical notes, a legal text, one information circular and its supplement, and few advance tax rulings are an almost exhaustive list of the documents which have been generated by GAAR.

Despite such little recourse to GAAR in the litigation process, GAAR has had a definite impact on the day to day life of those living off the fruits of tax planning: some self-restraint is warranted. Through GAAR, the government wanted to signal to the tax community that it would no longer be the late comer in the game of tax avoidance; it also wished to send a "do it if you dare" message. Interviews with tax practitioners demonstrates that the government was at least partially successful in reaching these objectives. Consequently, the first part of this chapter focuses on the documents generated under GAAR, the response of tax practitioners to GAAR and the influence of GAAR in the *Act*.<sup>2</sup> The second part defines GAAR's impact on tax avoidance through an examination of the judicial anti-avoidance doctrines which have continued to develop outside its realm of GAAR, but under its influence.

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<sup>1</sup> James G. Pearson, Revenue Canada, Chief, Tax Avoidance Services, Audit Technical Support Division, Audit directorate, however, reports that, as of December 31, 1994, 102 cases had been referred to the GAAR committee, 40 of which were not recommended, 51 were recommended, and 11 have a decision pending. See: Claude Déry, ed., *The Access Letter*, vol.5, no.10 (Montréal: Dacfo, Looseleaf).

<sup>2</sup> *Income Tax Act*, R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63, and as subsequently amended.

## A. Doctrinal Law developed under the General Anti-Avoidance Rule

### 1. Documents generated under GAAR

According to the Technical Notes, "section 245 of the *Act* is a general anti-avoidance rule which is intended to prevent abusive tax avoidance transactions or arrangements ... The new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance ..." <sup>3</sup> This rationale is full of good will and also consistent with Messrs. Arnold and Wilson's principles of drafting, <sup>4</sup> but is also based on the precarious assumption that the full extent of both legitimate tax planning and abusive tax avoidance is common knowledge on which everyone agrees.

In a parallel manner, subsection 245(2) of the *Act*, which is the charging provision of section 245, reads as follows:

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

Consequently, the determination of "legitimate tax planning" and "abusive tax avoidance" turn upon the definition of "avoidance transaction" referred to in subsection 245(2). Transactions that are not caught by the definition automatically qualify as legitimate tax planning transactions, and all the others fall in the abusive tax avoidance category.

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<sup>3</sup> Canada, Department of Finance, *Technical Notes to Bill C-139 (Royal Assent, September 13, 1988)* (Don Mills, Ontario: CCH, 1989) [hereinafter referred to as the "Technical Notes"] at 40,597.

<sup>4</sup> "The General Anti-Avoidance Rule-Part 2", (1988) 36 Can. Tax J. 1123-1185, at 1142ff.

The government's understanding of an "avoidance transaction" is defined in subsection 245(3) of the *Act*:<sup>5</sup>

An avoidance transaction means any transaction

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

Simply stated, an avoidance transaction means any transaction, whether or not it is part of a series of transactions, that:

(a) results in a tax benefit; and

(b) is not undertaken primarily for bona fide non-tax purposes.

This definition of avoidance transactions is far reaching.

It is, or should be, interpreted as being applicable to any transaction. Within the purview of section 245, "transaction" probably encompasses more than our imagination can read into it. The transaction can either be a single transaction or part of a series of transactions. If it is a single transaction, it includes an arrangement or event<sup>6</sup> which provides flexibility with regard to both the length of time allowed for a transaction to occur and the number of single events allowed to compose the transaction.<sup>7</sup> Therefore, a single transaction need not be a single event.

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<sup>5</sup> I deliberately refer to subsection 245(3)'s definition of an avoidance transaction as the government's understanding of it. Whether or not I agree with it shall be irrelevant in this chapter. In chapter four, however, I will argue that the government has, in its definition, adopted a slightly overbroad definition of tax avoidance which does not accurately reflect our socio-economic realities. See: p.137-138 below.

<sup>6</sup> *Income Tax Act*, *supra* note 2, subsection 245(1), definition of "transaction".

<sup>7</sup> Compare with interpretation of the words "transaction" or "operation" in former subsection 245(1), see: p.15 above.

In addition, the transaction can also be part of a series of transactions which "include any related transactions or events completed in contemplation of the series".<sup>8</sup> Regarding the scope of "transaction", I believe that the legislator has rightly left no loopholes and that, as such, any action of the taxpayers comes within the ambit of the law. Since the legislator chose to combat tax avoidance by a general rule, based on the *Stubart* experience, it is wise first to have a comprehensive approach and then, to formulate exceptions.<sup>9</sup>

Along the same line of thought, the legislator preserves this comprehensive approach by stating that any transaction will qualify as an avoidance transaction if it results in a direct or indirect tax benefit.<sup>10</sup> The current version of GAAR is different from the first draft proposal in that it does not require the tax benefit to be significant for a transaction to be an avoidance transaction. Personally, I believe this change to be a great improvement.

The explanatory notes, issued on June 18, 1987, attempted to explain "significant" as follows:

[g]enerally, for the purposes of proposed section 245, a transaction is defined to be an avoidance transaction if it has certain specified results, namely a significant reduction, avoidance, deferral or refund of tax and is not carried out primarily for bona fide business purposes. The reduction in tax must be significant. Rules are not provided as to what constitutes "significant"; this question must be determined in each case on its particular facts and it must be determined after the application of all other provision of the Act. For example, if a transaction results in an unreasonable deduction, section 67 is first applied to reduce the deduction to a reasonable amount. Only after the reduction would proposed section

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<sup>8</sup> *Income Tax Act*, *supra* note 2, subsection 248(10).

<sup>9</sup> *Stubart Investments Ltd. v. M.N.R.*, [1984] 1 S.C.R. 536, [1984] C.T.C. 294, 84 D.T.C. 6305. The reader will remember that Estey J. in *Stubart* refused to go beyond the scope of what he considered to be a general anti-avoidance provision -- section 245 of the *Act*, see: p.43 above. Accordingly, if the courts are not to go beyond the scope of GAAR, the legislator should attempt to close all possible loopholes that would be non desirable to him. As previously discussed, this approach is also consistent with Messrs. Arnold and Wilson's principles, see: pp.65-66, and 79-80 above.

<sup>10</sup> *Income Tax Act*, *supra* note 2, subsection 245(3).

245 be applied to determine if the transaction, by its nature and not its quantum, is an avoidance transaction because it results in significant reduction of tax.<sup>11</sup>

This attempted justification that the tax benefit be "significant" was fundamentally flawed. It is absurd to declare that "significant" should relate to the nature, as opposed to the quantum, of a transaction. First, it creates another category of transactions -- "non-significant" avoidance transactions -- gravitating outside the rationale for GAAR and having no definite legal status. Second, and notwithstanding the government's attempt to relate "significant" to the nature of transactions, "significant" undoubtedly related to their quantum. Grammatically, "significant" is an adjective qualifying the phrase "tax benefit". Any "tax benefit" is translated into an amount of money, or quantum. Therefore, "significant" cannot refer to the nature of transactions.

From a political perspective, the current version is also more valid. I suspect that "significant" was introduced in the draft version to calm those that would "hit the roof" at GAAR's proposal. I suggest that this approach was politically incorrect for two reasons:

- (a) in doing so, the government was sending a mixed message. Having taken the position that it would no longer be lenient in fighting tax avoidance, it then suggested that it would not stand by its word; and
- (b) in stating the law, the only distinction that the legislator is required to make is of what is, and what is not, reprehensible. Legally, there is either legitimate tax planning or abusive tax avoidance. Whether or not the tax benefit is significant does not preclude a transaction from being an avoidance transaction, although it can preclude it from being litigated for efficiency reasons.

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<sup>11</sup> Canada, Department of Finance, *Income Tax Reform by the Honourable Michael H. Wilson Minister of Finance* (Ottawa: Department of Finance, on June 18, 1987) at 138.

In summary, the government opted for a comprehensive approach, and any transaction resulting in a tax benefit is potentially an abusive tax avoidance transaction. Accordingly, "tax benefit" is also broadly defined:

"tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act.<sup>12</sup>

I cannot, myself, think of any tax benefit that does not come within this definition.

Having secured a broad definition of what constitutes an avoidance transaction, the government delineates exceptions which recognize the legitimacy of certain tax avoidance transactions. There are two exceptions. One is found in the definition of an avoidance transaction itself,<sup>13</sup> and the other one in subsection 245(4).

Subsection 245(3) provides that transactions having a primary non-tax purpose will not be deemed avoidance transactions even when they give rise to a tax benefit. Subsection 245(3) complies with Messrs. Arnold and Wilson's principles in that it establishes a criterion of distinction between legitimate and abusive tax avoidance transactions.<sup>14</sup> One may ask, however, if the criterion selected by the government is a valid criterion. The fact that the United Kingdom, the United States, Australia and New Zealand, and the civil law jurisdictions through their doctrine of abuse of rights, also selected the purpose of the transactions as central criterion to distinguish between both types of transactions may be indicative, but should not necessarily be conclusive.<sup>15</sup>

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<sup>12</sup> *Income Tax Act*, *supra* note 2, subsection 245(1).

<sup>13</sup> *Ibid.*, subsection 245(3).

<sup>14</sup> *Supra* note 4.

<sup>15</sup> United Kingdom, see: pp.71-75 above; United States, see: pp.75-78 above; Australia, see: p.78 above; New Zealand, see: p.78 above; and Civil Law Jurisdictions, see: pp.68-71 above.



Along with the purpose of the transactions, the motive and the amount of tax dollars saved could have been selected as criteria of distinction but, rightly I believe, were not.<sup>16</sup> Motive has been rejected in torts and criminal law as having any relevance in the finding of liability or guilt. The reason why you beat somebody does not matter, it is still a battery;<sup>17</sup> the reason why you steal somebody's purse does not matter, it is still theft.<sup>18</sup> What matters is that you intended to hit that person, or that you intended to appropriate to yourself something that was not yours. Similarly in contract law, the motive of entering into a contract has been rejected as having any bearing upon the validity of the contract.<sup>19</sup> Moreover, how on earth do you determine motive in this area of law where, near the year-end, people sit back and think: "God, I have made too much money, I should probably create a loss somewhere!" May as well create a motive that goes with it. Against this background, I see no reason to implement a motive criterion into taxation law. The validity of using the amount of tax dollars saved as a criterion of distinction has already been discussed and dismissed.<sup>20</sup> It may well be an administrative criterion which, for cost efficiency reasons, will result in abusive tax avoidance transactions which yield low tax savings not being tried, but it certainly has no place in the legislation to determine the nature of the transactions.

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<sup>16</sup> Either an objective or a subjective test can be used to determine the motive. According to the objective test, the motive is determined by reference to what the motive of a "reasonable person" would have been. According to the subjective test, the motive is the one of the taxpayer. I suggest that under either test, the motive of a transaction is not a valid criterion to distinguish between legitimate and abusive tax avoidance transactions.

<sup>17</sup> *Gilbert v. Stone* (1648), Style 72, 82 E.R. 539.

<sup>18</sup> *R. v. Lewis*, [1979] 2 S.C.R. 821, (1979) 47 C.C.C. (2d) 24 (S.C.C.).

Criminal law is a good example to distinguish between motive and purpose: in criminal law, where there are two elements to a crime -- the *actus reus* and the *mens rea* -- the motive is not determinative of the guilt of innocence. The purpose, or intention, is. A proven motive at its best is weighed as circumstantial evidence.

<sup>19</sup> *Smith v. Hughes* (1871), L.R. 6, Q.B. 597 (D.C.).

<sup>20</sup> See: p.91 above.

The purpose of the transaction therefore seems to be the only valid criterion upon which to base a distinction. Plain logic also ascertains its validity. Indeed, isn't it most natural to impose the legal consequences of tax avoidance transactions only on persons whose intention it is to achieve tax avoidance? However, subsection 245(3) does not attach legal consequences to transactions entered into for the purpose of avoiding taxes, but rather it addresses the situation in the negative. It is structured in such a way that any transactions resulting in a tax benefit will be deemed to have been entered into for the purpose of avoiding taxes, unless it can be proven that the transactions were entered into primarily for non-tax purposes. The Technical Notes attempt to explain how that primary purpose should be determined:

[w]here a transaction is carried out for a combination of bona fide non-tax purposes and tax avoidance, the primary purposes of the transaction must be determined. This will likely involve weighing and balancing the tax and non-tax purposes of the transaction. If, having regard to the circumstances, a transaction is determined to meet this non-tax purpose test, it will not be considered to be an avoidance transaction. Thus a transaction will not be considered to be an avoidance transaction because, incidentally, it results in a tax benefit or because tax considerations were a significant, but not the primary, purpose for carrying out the transaction.<sup>21</sup>

This explanation falls short of clarifying what facts will be pertinent in, first, determining and, second, weighing the purposes. In fact, this explanation does not express anything that one does not already know. Evidently, if the subsection refers to a "primary" purpose, it is because it addresses the issue that a transaction may have multiple purposes. Furthermore, it is implicit that one will have to weigh and balance the purposes in order to decide which is the primary one. It is obvious that the Technical Notes do not overwhelm one with their specificity any more than the legislative provision does. How, then, will the courts determine the legal implications of GAAR? GAAR, by its very nature, is a general provision, probably the most

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<sup>21</sup> Technical Notes, *supra* note 3 at 40,598.

general provision in the *Act*. As opposed to other provisions which secure their specificity by being facts specific, GAAR, to preserve its generality and inherent flexibility, elaborates around notions such as benefit, purpose, etc. ... Under GAAR, the courts have the responsibility to elaborate, within GAAR's structure, the corpus of these notions. The definite advantage of a judicial definition of legislative notions, as opposed to a legislative definition of the same, is that the corpus of the notions develops slowly, and its developments are always assessed against a factual situation. The corpus is even allowed to evolve and shift over time provided that the legislative framework is respected. To the contrary, a legislative definition would risk the same fate the specific anti-avoidance provisions had: easily circumvented.

The danger in having recourse to notions in statutory provisions whose corpus is to be judicially developed is that, even if everyone understands the notions, hardly anyone can explain them with a satisfactory level of accuracy. It will be for the courts to make the most of the flexibility of GAAR without slipping into confusion. The difficulty will lie in attempting to rationalize and define the notions upon which GAAR has been elaborated without confusing them with similar notions. With respect to the notion of the "purpose" of a transaction, as used in subsection 245(3), it is important not to confuse it with its "motive":

"[m]otive" must be distinguished from "purpose". "Motive" is the reason why; "purpose" is the aim, or object, or end in view. Both words must be distinguished from "effect", which is the result achieved, actual consequences. If a man points a loaded revolver at another's head and pulls the trigger, his *motive* may be greed or jealousy, or revenge; his *purpose* is to kill; the *effect* is the victim's death. Indeed, he may shoot without any motive at all; but his action cannot lack purpose or (unless he misses) effect.<sup>22</sup> [emphasis in original]

Mr. Millett defines the notion of "purpose" by analogy.

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<sup>22</sup> Peter Millett Q.C., "Artificial Tax Avoidance: The English and American Approach", 1986 B.T.R. 327-339 at 330.

There are in fact three ways to deal with notions in general: one can use the Socratic approach, one can "feel" the notions, or one can visualize them by using analogy. The danger with the Socratic approach is to reach the same results as Socrates did: I know that I do not know. This only leaves open the other approaches. On the one hand, I believe that the "feeling" approach, because it has no link with a defined object (in other words it has no point of reference) has a greater propensity to lead to irrationality, inconsistency and subjectivity. On the other hand, I believe that the visualizing approach, because it forces one to build upon a defined object by analogy, would more likely lead to rationality and consistency, and relieve the notion from much of its subjectivity. Moreover, this technique conforms with the accepted principles of human reasoning and development.<sup>23</sup>

In the quest for rationality and consistency, variety in the terminology used to refer to the purpose of transactions is warranted neither for the courts nor for the commentators. The more limited and precise it is, the less probable that it will inadvertently expand the concept.<sup>24</sup> Although, in tax avoidance cases, the motive and purpose of the transaction will often be the same -- that is the avoidance of taxes -- confusion between the notions should be avoided or the policy behind GAAR lost. In this regard, the Canadian International Trade Tribunal in *Michelin*

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<sup>23</sup> Harry Abravanel et al., *Individu, Groupe et Organisation* (Montréal, Qc.: Gaétan Morin, 1986) at 145: Il faut associer l'inconnu au connu et relier les nouvelles idées aux idées précédentes. La compréhension vient souvent par association d'idées, c'est-à-dire par perception des ressemblances et des différences entre les objets, les événements et les personnes. Il est donc plus facile de comprendre une nouvelle idée lorsqu'on peut l'associer à une idée déjà connue. La technique de la comparaison permet d'identifier les similitudes alors que celle du contraste permet d'identifier les différences.

See also: Jean Piaget, *Psychologie de l'Intelligence*, rev. ed. (Paris, France: Armand Colin, 1981).

<sup>24</sup> In this regard see: Vern Krishna, *Tax Avoidance: The General Anti-Avoidance Rule* (Toronto: Carswell, 1990) at 47. Mr. Krishna mixed purpose with motive, intention and reason for doing something.

*Tires Canada Ltd. v. M.N.R.* appears to have carefully chosen its words.<sup>25</sup> "Intention" was the only synonym of the word used by the Tribunal, but *Michelin* did not explain how the purpose of the taxpayer in carrying out a transaction should be ascertained, let alone the primary purpose determined.

The requirement that the non-tax purpose be the primary purpose of the transaction is unfortunate in terms of relieving GAAR from subjectivity. How does one establish a primary purpose? The "weighing and balancing of the tax and non-tax purposes" may look good on paper, but I ask: practically, does it work? I realize that the government may have introduced this "primary" requirement into the legislation to prevent tax avoiders from making up an "after-the-fact-non-tax-purpose" to salvage their transactions. Nonetheless, any such "made-up-non-tax-purpose" is likely to be legally weak, and accordingly should not satisfy the balance of probabilities. A non-proven non-tax purpose is as good as non-existent; and a non-existent non-tax purpose does not fulfil the exception to an avoidance transaction created by subsection 245(3). I agree, however, that there may be mixed purposes to a transaction and as such, I would suggest that the exception requires a reasonably credible, non-tax purpose rather than a primary non-tax purpose. Such requirement would also be more in accordance with the commercial reality approach recently adopted by the courts.<sup>26</sup> Reasonableness is a notion familiar to the courts as many statutes refer to it. In this particular context, reasonableness would permit the courts to avoid the puzzle of qualifying the non-tax purpose of a transaction as to whether it is primary, significant, substantial or any other adjective that might be used. Reference to a reasonably credible non-tax purpose should imply that there may be situations

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<sup>25</sup> 3 G.T.C. 4040 [hereinafter referred to as *Michelin*]. *Michelin*, albeit not directly interpreting GAAR, interpreted section 274 of the *Excise Tax Act*, R.S., c. E-12, which contains identical definitions of an "avoidance transaction" and "tax benefit" to section 245 of the *Act*.

<sup>26</sup> See: pp.118-133 below.

where transactions having a non-tax purpose of lesser importance, but unquestionably existent, may still be legitimate. The criteria of reasonableness should be left for the courts to determine. I think that when a taxpayer can allege and substantiate a non-tax purpose in a transaction, and the courts are satisfied with the credibility of such a purpose, the transaction should pass the reasonableness test.

Paragraph 245(3)(b) of the *Act* legislatively introduces an altered version of the step transactions doctrine. It reads as follow:

[a]n avoidance transaction means any transaction

(a) ...

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

The concurrent application of subsection 245(2) and paragraph 245(3)(b) to a transaction results in the denial of any tax benefit arising from a series of transactions when any single transaction in the series lacks a non-tax purpose. The Technical Notes express the government's rationale underlying the paragraph in the following terms:

[n]ew paragraph 245(3)(b) recognizes that one step in a series of transactions may not by itself result in a tax benefit. Thus, where a taxpayer, in carrying out a series of transactions, inserts a transaction that it not carried out primarily for bona fide non-tax purposes and the series results in a tax benefit, that tax benefit may be denied under subsection 245(2).<sup>27</sup>

This approach to series of transactions is a clear departure from the approach adopted in the United Kingdom.<sup>28</sup> In the United Kingdom, the courts look at the purpose of each of the various transactions composing the series in order to override the *Duke of Westminster* principle

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<sup>27</sup> Technical Notes, *supra* note 3 at 40,599.

<sup>28</sup> See: pp.71-75 above.

and, consequently, to consider the series as a whole. In Canada, under GAAR, the courts first consider the series and, then, break it down in its different components. If even one single component fails to yield a primary non-tax purpose, the entire series loses its tax benefit.

I find this approach most drastic and inappropriate. As a remedy, subsection 248(10) should be amended.<sup>29</sup> The definition of a "series of transactions" found in this subsection should be narrower. What transactions do, in fact, form a series? I suggest that in answering this question, two elements should be considered:

(a) whether all transactions are interdependent *i.e.* whether the first transaction sets the basis for the second transaction and the second gives a reason for the first to have occurred; and

(b) whether all transactions composing the series have a common purpose.<sup>30</sup>

Based on these criteria, if the courts are faced with a series of transactions that as a whole has a reasonable non-tax purpose then, the individual purposes of each transaction should be irrelevant to them. Stating otherwise may result in the negation of the principle that taxpayers are allowed to arrange their affairs so as to attract the least possible amount of tax, a principle by which the government abides.<sup>31</sup>

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<sup>29</sup> *Income Tax Act*, *supra* note 2, subsection 248(10) which provides:

**Series of transactions.** -- For the purposes of this Act, where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series.

<sup>30</sup> The case law has developed a similar position. See: *454538 Ontario Ltd. v. M.N.R.*, 93 D.T.C. 427, [1993] 1 C.T.C. 2746 (T.C.C.) at 2753:

[I]t seems reasonable to conclude that in order for the events to form part of a series they must follow each other in time and must somehow be logically or reasonably connected to one another. Furthermore the [parties to the series of transactions] must intend that the series of transactions be linked together to achieve the specific results ...

Cited with approval in *C.P.L. Holdings Ltd. v. M.N.R.*, 95 D.T.C. 5253 (F.C.T.D.) at 5260.

I suggest that the intention of the parties does not have to be part of the definition; a mere objective review of each of the transactions should suffice in determining whether or not they are linked together.

<sup>31</sup> Technical Notes, *supra* note 3 at 40,599.

In its Technical Notes, the Department of Finance stated that: "it [subsection 245(3)(b)] does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes."<sup>32</sup> In light of the wording of subsection 245(3), it would seem that either the Department of Finance lied in this statement or does not understand the subsection. I believe that the above statement is politically correct and that it is subsection 245(3) which should be amended accordingly. Once again, and it cannot be stressed enough, the Department of Finance probably did not properly isolate the United Kingdom's approach from its own.

Some characteristics of the English approach are present in subsection 245(3) but lead to an absurdity as the factual settings in the two countries are different:

(a) in the United Kingdom, to fight tax avoidance, the courts, through the step transactions doctrine, created a way to acknowledge the fact that they were not dealing with separate transactions but with a series of transactions, thereby overriding the traditional approach to tax transactions; and

(b) in Canada, the government created, through subsection 245(3), a factual setting which already acknowledges that there is such a thing as a series of transactions.

In the United Kingdom, once the purpose of the components to a series of transactions has been determined and one is allowed to look at the series as a whole, such purpose becomes irrelevant in deciding the tax treatment of the series. Why is it that in Canada, under subsection 245(3), once a series of transactions has been identified, then the purpose of each component becomes crucial in deciding the tax treatment of the series? What is the rationale that allows one to

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<sup>32</sup> *Ibid.*



ignore the common purpose of a series of interdependent transactions in favour of individual purposes? It seems to me that there has been a loss of focus somewhere.

The exception contained in subsection 245(4) provides that subsection 245(2) does not apply when the transaction under scrutiny does not result "in a misuse of the provisions of this Act [the *Income Tax Act*] or an abuse having regard to the provisions of the Act, ..., read as a whole." Subsection 245(4) brings the *Act* to term with the "object and spirit" approach of Estey J. in *Stuart*, and with section 12 of the *Interpretation Act*.<sup>33</sup>

As Estey J. propounded the "object and spirit" approach because "[i]t 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",<sup>34</sup> the Department of Finance enacted subsection 245(4) for the following reasons:

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. It also recognizes, however, that a number of provisions of the Act either contemplate or encourage transactions that may seem to be primarily tax-motivated. ... It is not intended that section 245 will apply to deny the tax benefits that result from those transactions as long as they are carried out within the object and spirit of the provisions of the Act read as a whole. Nor is it intended that tax incentives expressly provided for in the legislation would be neutralized by this section.<sup>35</sup>

It is recognized today that the *Act* is much more than a mere revenue-raising instrument; it has become an important means of implementing social policy. "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

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<sup>33</sup> R.S.C., 1985, c. I-21.

<sup>34</sup> *Stuart*, *supra* note 9 at 6322.

<sup>35</sup> Technical Notes, *supra* note 3 at 40,599.

governing the community. Income taxation is also employed by the government to attain selected economic policy objectives."<sup>36</sup> This use of the *Act* by the government, called tax expenditure, has developed since the late 1960's. The funds foregone by the taxing authorities through tax incentives are called tax expenditures.<sup>37</sup> Because the *Act* embodies an expenditure program, it, more than any other statute (with the exception of criminal or penal statutes) which regulates people's activities, has the potential to influence the making of one decision over another;<sup>38</sup> and because the government utilises it to achieve social and economic policy, it is important that its provisions be used according to their intent. Therefore, it seems only logical that provisions used in a way that negates their intent -- misused or abused provisions -- be qualified as avoidance transactions. Nonetheless, reference in the subsection to the misuse and abuse of the provisions of the *Act* raises the difficult question of how misuse or abuse are to be determined.<sup>39</sup> Undoubtedly, any ruling on the issue of misuse or abuse of a provision should involve an analysis of the policy reasons underlying it. In order to dispel the uncertainty related to such a process, when courts come across cases where the issue of misuse or abuse arises, the policy analysis of the particular provision should be stated in the case and not merely the conclusion stemming from it. This analysis would then become part of the *ratio* of the case, subject to the *stare decisis* doctrine. Needless to say that this would give rise to a rich body of

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<sup>36</sup> *Stubart*, *supra* note 9 at 6322.

<sup>37</sup> Neil Bruce, "Pathways to Tax Expenditures: a Survey of Conceptual Issues and Controversies" (The 7th John Deutsch Roundtable on Economic Policy, 1988) 21. A. Premchand, *Government Budgeting and Expenditure Controls: Theory and Practice* (Washington, D.C.: International Monetary Fund, 1983).

<sup>38</sup> For example a difference in the tax rates of capital gains and dividends could favour investments in more senior companies which pay out yearly dividends, but whose shares value is more stable, over investments in venture companies which do not pay out dividends, but whose shares value fluctuates.

<sup>39</sup> See: pp.104-106 below.

jurisprudence which would further the government's social policies and satisfy the taxpayers' needs for certainty.

The Department of Finance concedes that subsection 245(4) "draws on the doctrine of abuse of rights".<sup>40</sup> I have already discussed the arguments against the introduction in Canadian taxation law of the abuse of rights doctrine and concluded that they were not convincing.<sup>41</sup> The introduction of the doctrine, as far as it is considered to be a revolution of the common law, should not be a problem. If there is a problem, I suspect that it will come from the bench. Indeed, judges are accustomed to the more specific and factual approach to tax cases and such introduction of a notional approach may require an adaptation period.

Concurrently with the coming into force of GAAR, the Department of Finance issued an Information Circular whose purpose is "to provide guidance with respect to the application of the general anti-avoidance rule."<sup>42</sup> A supplement was also issued subsequently.<sup>43</sup> The comments included in the Information Circulars do not reveal any more of the profound meaning of each of the subsections than did the Technical Notes. The scenarios given as examples and interpretations of the same, however, are more helpful in interpreting subsection 245(4). Unfortunately, these scenarios and interpretations are of very little use in interpreting subsection 245(3) as each scenario is, for the purposes of the Information Circulars, deemed to have been entered into primarily for the purpose of obtaining a tax benefit. Accordingly, the Information

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<sup>40</sup> Technical Notes, *supra* note 3 at 40,600.

<sup>41</sup> See: pp.83-84 above.

<sup>42</sup> *Information Circular 88-2, General Anti-Avoidance Rule Section 245 of the Income Tax Act*, dated October 21, 1988.

<sup>43</sup> *Information Circular 88-2, Supplement 1, General Anti-Avoidance Rule*, dated July 13, 1990 [*Information Circular 88-2* and *Information Circular 88-2, Supplement 1*, are hereinafter referred to as *Information Circular* and *Information Circular Supplement* respectively or conjunctively as the "Information Circulars"].

Circulars do not yield any information regarding the ascertaining of the purpose of the transactions. Consequently, the sole issue to be determined in the scenarios is whether or not the transactions resulted in a misuse or abuse of the provisions of the *Act* read as a whole.<sup>44</sup>

Eight principles can be inferred from the Information Circulars:

(a) if the transactions comply with the object and spirit of the provisions, then section 245 should not apply;<sup>45</sup>

(b) if the transactions do not comply with the object and spirit of the provisions, then the first reaction of the Department of Finance should be to turn to applicable specific provisions;<sup>46</sup>

(c) if the transactions do not comply with the object and spirit of the provisions, and defeat specific provisions, then section 245 should apply;<sup>47</sup>

(d) the question of whether or not the transactions comply with the object and spirit of the provisions can sometimes be determined by implication. By implication, if a specific

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<sup>44</sup> *Information Circular*, *supra* note 42 paragraph 6; *Information Circular Supplement*, *ibid.* paragraph 2.

<sup>45</sup> See *e.g.*: *Income Tax Act*, *supra* note 2 subsection 245(4); *Information Circular*, *supra* note 42 paragraph 7.

<sup>46</sup> See *e.g.*: *Information Circular*, *ibid.* paragraphs 7 and 13. The tax scheme exemplified in paragraph 13 is that of a corporate taxpayer who uses the rollover provision of subsection 85(1) to transfer property to an arm's length corporation and accordingly receives the profit as a taxable dividend deductible under subsection 112(1) rather than as income or capital gain, or both. In this particular case, the Department of Finance contended that "if the property transferred is non-depreciable capital property, subsection 55(2) applies ... subsection 245(2) would, therefore, not apply."

<sup>47</sup> See *e.g.*: *Information Circular*, *ibid.* paragraphs 7, 8, 13, 14, 22 and 23. The tax scheme exemplified in paragraph 23 is that of a taxpayer who enters into a series of transactions to avoid the application of section 80 on a forgiveness of debt. "In the situation the transfer of the assets of the taxpayer to the wholly-owned subsidiary that is undertaken solely to avoid the results of a straightforward forgiveness of the debt would be subject to subsection 245(2)."

act is prohibited and there is no mention, either in the provision or in the *Act*, that its opposite act is also prohibited, then the opposite should be allowed;<sup>48</sup>

(e) if there is no indication in the *Act* that some transactions would be either approved or disapproved, then section 245 should not apply;<sup>49</sup>

(f) if the transactions take advantage of tax incentives in a forthright way, then section 245 should not apply;<sup>50</sup>

(g) if the transactions use the literal interpretation of tax incentives to take advantage of them and to avoid concurrently the tax liability imposed by other provisions, then section 245 should apply;<sup>51</sup> and

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<sup>48</sup> See *e.g.*: *Information Circular*, *ibid.* paragraph 9. The tax scheme exemplified in paragraph 23 is that of a person who rolls over property to a related corporation and such rollover is followed by the sale of the said property to a third party. The purpose of the scheme was to write off the unrealized capital gain in the property against the related corporation's capital loss. Subsection 69(11) would not permit the transaction in the case of a rollover to an unrelated corporation. "By implication, the subsection does permit a transfer to a related corporation on a tax deferred basis."

<sup>49</sup> See *e.g.*: *Information Circular*, *ibid.* paragraphs 8 and 11; *Information Circular Supplement*, *supra* note 41 paragraphs 3 and 5. The tax scheme exemplified in paragraph 11 is that of the incorporation of a proprietorship. "There is nothing in section 125 or elsewhere in the *Act* that prohibits an individual from incorporating his or her business. The incorporation is consistent with the *Act* as a whole and, therefore, subsection 245(2) would not apply to the transfer of the business to the corporation."

<sup>50</sup> See *e.g.*: *Information Circular*, *ibid.* paragraphs 13 and 18. The tax scheme exemplified in paragraph 11 is that of a CCPC which pays a salary to its shareholder/manager in a reasonable amount which nonetheless reduces the corporation's income to its business limit. "Subsection 245(2) would not apply to the payment as the *Act* recognizes the deductibility of reasonable business expenses."

<sup>51</sup> See *e.g.*: *Information Circular*, *ibid.* paragraphs 12, 21, 26 and 27; *Information Circular Supplement*, *supra* note 41 paragraph 6. Paragraph 21 has the following facts:

An operating corporation merges with a shell corporation in an amalgamation described in subsection 87(1) of the *Act*. This merger is undertaken solely for the purpose of having the rules in paragraph 87(2)(a) deem the taxation year of the operating company to end immediately before the amalgamation, which year end will produce a tax benefit.

Paragraph 21 consequently has the following interpretation:

The definition of "fiscal period" in subsection 248(1) of the *Act* states that no change in the usual and accepted fiscal period may be made without the concurrence of the Minister. The use of the rules of subsection 87(2) to circumvent this requirement would be a misuse of subsection 87(1) and consequently subsection 245(2) would apply.

(h) the Department of Finance should not seek the application of section 245 if one provision of the *Act* already applies to the transactions in a more favourable manner.<sup>52</sup>

The case law will confirm or negate the concrete application of these principles. At this point in time, however, tax planners should check their transactions against the examples contained in the Information Circulars, the two published advance tax rulings involving GAAR<sup>53</sup> and *Michelin*.

It seems to me upon reading the principles that the Department of Finance is struggling with the application of GAAR. It appears that the Department tries in its Information Circulars to point out as many examples as possible where GAAR would not apply. Did it attempt to calm down angry tax planners? Certainly principles (a), (b), (f) and (h) are merely the result of the application of subsection 245(4) although the Department makes it sound like at face value GAAR does not apply at all. One should understand that subsection 245(4) is structured in such a way that its own application will lead to the non-application of GAAR.

Principles (d) and (e) deal with the application of GAAR by necessary implication. These principles are surely in accordance with basic fairness. However, they are silent as to the indication required to trigger the application of GAAR by necessary implication. Should the courts conclude that an express indication is required, I contend that it defeats GAAR's purposes.

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<sup>52</sup> See *e.g.*: *Information Circular*, *ibid.* paragraph 16. Paragraph 16's interpretation is self-explanatory. Section 78 ... does not deny the deduction of a bona fide expense to a taxpayer in the year that it is incurred. It does, however, provide that either the taxpayer or the non-arm's length person will include the amount in income in the third taxation year following the year in which the expense is incurred. The deferral in such circumstances [the actual payment occurred at the end of the second taxation year] is contemplated by subsection 78(1) of the Act and subsection 245(2) would apply. Should the deferral be not contemplated by subsection 78(1), it is implied that subsection 245(2) would apply.

<sup>53</sup> *Advance Tax Ruling - 35*, Partitioning of Assets to get Specific Ownership -- "Butterfly", dated November 4, 1998; *Advance Tax Ruling - 50*, Structured Settlement, dated August 28, 1992.

Is the Department of Finance trying to reach a compromise with tax planners? It should not, because they will not.

## 2. GAAR in the Income Tax Act

In the application of GAAR, uncertainty lies not only in the meaning of its different components, but also its interplay with the other anti-avoidance measures of the *Act*. The Technical Notes provide that "[t]he new rule applies as a provision of last resort after the application of the other provisions of the *Act*, including specific anti-avoidance measures."<sup>54</sup>

What does the Department of Finance mean by "provision of last resort"? Is it that section 245 will apply only in situations where no specific anti-avoidance measures are applicable? I do not believe so. Although the Technical Notes do not elaborate upon the inner meaning of the above statement, the explanatory notes contain an example which, I think, may explain the phrase.<sup>55</sup> According to these notes, if a transaction falls within the scope of a specific measure, the specific measure should be first applied to the transaction, then GAAR would apply to the resulting transaction to determine if it is an avoidance transaction. "For example, if a transaction results in an unreasonable deduction, section 67 is first applied to reduce the deduction to a reasonable amount. Only after the reduction would ... section 245 be applied to determine if the transaction ... is an avoidance transaction ..."<sup>56</sup>

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<sup>54</sup> Technical Notes, *supra* note 3 at 40,597.

<sup>55</sup> *Income Tax Reform*, *supra* note 11 at 138.

<sup>56</sup> *Ibid.*

The explanatory notes were written in respect of an earlier version of GAAR, accordingly, the omissions are inserted in the citation to take into account the amendments made to proposed section 245 in the course of enacting GAAR. I do not believe, however, that the amendments to that earlier version have an impact on the Department's approach to GAAR.

Despite this naive wish to keep the interactions between GAAR and the specific provisions simple, when one deals with the *Act*, wishes for simplicity usually remain exactly what they are: wishes. Thomas E. McDonnell examined what pattern the interactions could take and reached more complex conclusions.<sup>57</sup> Mr. McDonnell contends that there are at least five sets of circumstances in which GAAR should not override a specific rule, they are where:

(a) "the specific rule is based on a results test and the result of the transaction is not within the specific rule";<sup>58</sup>

(b) "the specific rule itself specifies in detail the tax consequences of the transaction, and the transaction falls within a relieving provision in that rule";<sup>59</sup>

(c) "the specific rule is expressed to apply notwithstanding any other provision of the *Act*";<sup>60</sup>

(d) "the specific rule is expressed to determine the tax consequences that are 'reasonable in the circumstances'";<sup>61</sup> and

(e) "it is apparent from the scheme of the specific rule that Parliament did not intend to tax a particular type of transaction."<sup>62</sup>

In support of statement (a), Mr. McDonnell relied on subsection 55(2) of the *Act*. Incidentally, with respect to the relationship between GAAR and that subsection, the Department

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<sup>57</sup> Thomas E. McDonnell, "Legislative Anti-Avoidance: the Interaction of the New General Rule and Representative Specific Rules", *Report of the Proceedings of the Fortieth Tax Conference* (1988 Conference Report), Toronto, C.T.F., 1989, 6:1-34.

<sup>58</sup> *Ibid.* at 6:34.

<sup>59</sup> *Ibid.*

<sup>60</sup> *Ibid.*

<sup>61</sup> *Ibid.*

<sup>62</sup> *Ibid.*



of Finance, in paragraphs 7 and 15 of the *Information Circular*, reaches the same conclusions as Mr. McDonnell. However, it reaches its conclusions by applying GAAR and concluding that, in the specific cases described in the *Information Circular*, it would not, pursuant to subsection 245(4), apply GAAR. This rationalization process contrasts with Mr. McDonnell's which contends that GAAR should not apply in the situations described in (a) as a matter of principle. I believe that the Department's approach is, of the two, the most appropriate in that it acknowledges GAAR's structure. GAAR and the specific provisions have conflicting tests: results and primary purpose. Their combination may bring about four different situations:

- (i) the transaction has a primary non-tax purpose but its results are within the specific rule;
- (ii) the transaction has a tax purpose and its results are within the specific rule;
- (iii) the transaction has a primary non-tax purpose and its results are not within the specific rule; or
- (iv) the transaction has a tax purpose and its results are not within the specific rule.

The issue here is whether GAAR should apply. Contrary to Mr. McDonnell's contentions, I suggest that GAAR applies in all of the four above situations and whether adverse consequences follow from it is the very result of its application.

Obviously, situations (i) and (iii) will not bear any adverse consequences as the transactions do not come within the definition of an avoidance transaction. However, this can only be ascertained after applying GAAR to the particular set of facts. The same is true with situations (ii) and (iv) with the exception that the intellectual exercise of applying GAAR to conclude of its non-application takes place within subsection 245(4). The only occasion where this approach would lead to results different than those envisaged by Mr. McDonnell is when the transaction fails to come within the specific rule because the taxpayer entered into a scheme

to avoid the rule. In this situation, Mr. McDonnell's approach would permit circumvention of the application of GAAR. Consequently, I cannot agree with it.

The same comments also apply to statements (b), (d) and (e). With respect to the latter, one should acknowledge that, in most cases, the tax consequences would be the same whether the specific rule or GAAR is applied, but when these cases occur, the principle is not so much that GAAR "should not override" as "GAAR does not need to override". In other cases, as Mr. McDonnell admitted, GAAR should override the specific rules since, as opposed to specific rules, GAAR also provides for the adjustment of the tax consequences to third parties.<sup>63</sup> Personally, I fail to see why third parties should benefit from the adjustment of tax consequences only when the specific provisions and GAAR do not yield the same tax consequences to direct parties.

Only in the situations covered by statement (c) would I agree with Mr. McDonnell that GAAR should not override the specific provisions. In these situations there is no doubt that GAAR should not override the specific rule without even having recourse to GAAR so that its self-censure can occur. If the Department of Finance seeks another result, it can amend the specific rules in either one of two ways. The Department could either repeal the phrase "notwithstanding any other provisions of the Act" or add to it the phrase "with the exception of section 245".

Situations covered by statement (c) are accordingly the only ones where GAAR should not apply as a matter of principle. In all other situations, GAAR's construction should lead to a self-censure. Nonetheless, in situations "[w]here a transaction may be assessed under both a

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<sup>63</sup> *Ibid.* at 6:7.

specific rule and the GAAR, the minister ought to assess under the specific rule unless the use of the GAAR would result in less onerous taxation, or prevent an unfair result ..."<sup>64</sup>

Mr. McDonnell further submits that it would be improper to use GAAR to tax a benefit that would not otherwise fall within the scope of the specific rule because of an established judicial principle.<sup>65</sup> With all due respect, Mr. McDonnell seems to forget that the legislator can, in enacting a law, change the existing doctrinal law. If his contention were correct, it would imply that, in enacting GAAR, the legislator did not want to disturb the law as it existed prior to GAAR. I believe, to the contrary, that the Department of Finance's dissatisfaction with the state of the law on tax avoidance was one of the key elements that led to GAAR.<sup>66</sup>

In addition to the issue of what principles should govern the relations between GAAR and the specific rules of the *Act*, the enactment of additional specific rules since 1988 may cause perplexity. If the government went through all the trouble of conceiving GAAR, facing the critiques and finally enacting it, why has it been enacting more specific rules after GAAR? Was GAAR not supposed to attack tax avoidance globally? Why does the taxation system need more specific rules? Does the government not believe in GAAR any longer? What has ever happened to the objective of simplicity? The answers to these questions are speculative yet logical.

With respect to the objective of simplicity, it is fair to say that in these modern days, circumvention of tax avoidance prevails over the objective of simplicity. Moreover, the entire structure of the *Act* suggests that although the objective of simplicity remains a part of political talks, simplicity in the *Act* has been foregone for some time already. The structure of the *Act*

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<sup>64</sup> *Ibid.*

<sup>65</sup> *Ibid.* at 6:9.

<sup>66</sup> See: pp.48-63 above.

is circumvoluted. The structure of the various sections of the *Act* itself is circumvoluted. The rationales behind the provisions of the *Act* are far from transparent. Accordingly, a discussion of the above questions should focus on the reasons for the enactment of the specific rules rather than condemning such enactments in the name of simplicity which is no more than a political facade.

There are at least four reasons why, despite the presence of GAAR in the *Act*, the enactment of specific anti-avoidance rules is warranted:

- (a) specific rules should be enacted when the government desires a different test than the one put forward in GAAR to apply to specific situations;
- (b) specific rules should be enacted when some direction as to what does, or does not, constitute a misuse or abuse of the provisions of the *Act* is required;
- (c) specific rules should be enacted when the Department of Finance seeks either a more or a less favourable treatment of specific avoidance transactions than the one provided for in GAAR; and
- (d) specific rules might have been enacted to assist Revenue Canada in tax avoidance cases.

With respect to reason (a), it has been pointed out that some specific rules have a test different than GAAR's test to determine tax avoidance. In enacting GAAR, the government did not freeze the state of anti-avoidance laws, it simply provided itself with a very thorough and encompassing, albeit static, anti-avoidance rule. However, the state of tax avoidance evolves as lawyers develop different schemes which tend to be always more ingenious than the preceding ones, and the Department of Finance might decide to react to such schemes.

With respect to reason (b), I have mentioned that, sometimes, one can determine by inference whether or not the transactions comply with the object and spirit of the provisions of

the *Act*.<sup>67</sup> If a specific act is prohibited and there is no mention, either in the provision or in the *Act*, that its opposite act is also prohibited, then the opposite should be allowed. Moreover, if there is no indication in the *Act* that some transactions would be either approved or disapproved then, section 245 should not apply. Consequently, as GAAR does not apply, because of subsection 245(4), when there is no indication of misuse or abuse of the provisions of the *Act*, the enactment of a specific anti-avoidance rule may be necessary to provide such indicia.

Finally, reason (d) has two components. Firstly, it should be considered that GAAR has introduced a new approach to deal with tax avoidance. This new approach can be troublesome for tax practitioners in private practice, Revenue Canada's officials and the courts, as most of them are uncomfortable in dealing with the doctrine of abuse of rights. Specific rules provide them with some certainty that they cannot find in GAAR. Secondly, there is some strong evidence that the courts' interpretation of GAAR will not be generous and liberal.<sup>68</sup> Accordingly, GAAR will probably not turn out to be the ultimate weapon the Department of Finance had desired and specific anti-avoidance rules will probably remain a necessity.

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<sup>67</sup> *Supra* notes 48 and 49. See also: p.106 above.

<sup>68</sup> See: pp.118-133 below.

### 3. GAAR's Influence on Tax Planning Practices

Despite very little litigation to date under the new section 245 of the *Act*, and strong evidence that GAAR will receive a very narrow interpretation, GAAR has had some deterrent influence on tax planning practices.<sup>69</sup>

GAAR's influence is most noticeable in large practices where prominent tax avoidance schemes are normally elaborated, whereas small practices will, in general, service individual or small corporate clients whose financial means and statutory opportunities, are usually limited.<sup>70</sup> Advanced aggressive tax planning and avoidance is more likely to be conducted in larger practices which attract clients of greater means.

GAAR's influence, however, is not definitive. It is more like a concern which permanently weighs on the mind of tax practitioners but only materializes at precise yet indeterminate moments. Tax practitioners agree that they have at least, in each transaction, to be cognizant of the existence of GAAR.<sup>71</sup> GAAR has added a new dimension to tax planning. A few years ago, the purpose of a transaction was simply irrelevant to its validity. With GAAR, the purpose of a transaction has become an important part of tax planning. As part of the planning, time is now devoted to ensuring that transactions have a non-tax purpose. Tax

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<sup>69</sup> *Ibid.*

GAAR's deterrent effect transpired from different interviews with tax practitioners. The principal questions asked during those interviews are the following:

- (a) has GAAR forced you to request more ATR?
- (b) is there such thing as abusive tax avoidance?
- (c) what is your opinion about a *Charter* challenge to GAAR?
- (d) has GAAR modified the way you advise your clients?
- (e) has GAAR modified the way you practice taxation law?
- (f) how do your clients feel about GAAR?

<sup>70</sup> Interview with Wing Jang, *Mario M. Montagano, Chartered Accountant* (June 1995) Vancouver.

<sup>71</sup> Telephone interview with William A. Ruskin, *Clark Wilson, Barristers & Solicitors* (July 1995) Vancouver.

practitioners can become very imaginative in order to give a non-tax purpose to transactions.<sup>72</sup> As a general rule, tax practitioners now abstain from entering into tax avoidance schemes to which the Department of Finance has already declared, in its Information Circulars, GAAR would apply.<sup>73</sup> This general rule makes sense as the final decision as to whether or not one should enter into a transaction lies in the client's hands. Normally, the client does not like to spend money on dead ends.<sup>74</sup> It happens, occasionally however, that the client will simply decide to ignore GAAR and proceed with the transaction.<sup>75</sup> Businesspeople are often inclined to take calculated risks, and GAAR is one.

Although GAAR causes much uncertainty, advance tax rulings have not been sought in greater number than they were prior to its enactment.<sup>76</sup> Mr. Ruskin, although he cannot explain this phenomenon, noticed that fewer advance tax rulings have in fact been sought in his practice since GAAR.<sup>77</sup> Mr. Kellough reported that he had not sought any advance tax rulings which were directly related to GAAR.<sup>78</sup> According to Mr. Nitikman, however, GAAR added a new dimension to those advance tax rulings that were sought.<sup>79</sup> Although none of the tax

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<sup>72</sup> *Ibid.*

<sup>73</sup> *Ibid.* Interview with Ross Tunnicliffe, *McRae, Holmes & King, Barristers & Solicitors* (April 1995) Vancouver.

<sup>74</sup> Telephone interview with W. A. Ruskin, *supra* note 71.

<sup>75</sup> Telephone interview with Joel A. Nitikman, *Fraser & Beatty, Barristers & Solicitors* (July 1995) Vancouver.

<sup>76</sup> Telephone interview with W. A. Ruskin, *supra* note 71; Interview with R. Tunnicliffe, *supra* note 73; Telephone interview with J. A. Nitikman, *ibid.*; Telephone interview with Howard J. Kellough, *Fraser & Beatty, Barristers & Solicitors* (July 1995) Vancouver.

<sup>77</sup> Telephone interview with W. A. Ruskin, *ibid.*

<sup>78</sup> Telephone interview with H. J. Kellough, *supra* note 76.

<sup>79</sup> Telephone interview with J. A. Nitikman, *supra* note 75.

practitioners interviewed could explain unequivocally the reason why the number of advance tax rulings sought was so low, I believe that it has something to do with the fact that they are binding. A reading of the case law on tax avoidance leaves the impression that Revenue Canada is more hostile to tax avoidance than the courts are. Indeed, if it were not, it would probably win all the cases it takes to court. Consequently, I suspect that most clients would prefer to take their chances with the courts where they can be heard, rather than with Revenue Canada where they have no voice.

The one area where GAAR has probably had the greatest influence is in letters of opinion. Tax practitioners usually discuss GAAR with their clients and include a special clause to this effect in almost all of their letters of opinion. The rare occasions where a "GAAR clause" is not part of a letter of opinion is when the non-application of GAAR is obvious. By reason of the wide scope of GAAR's charging provision, such occasions are most scarce. A typical "GAAR clause" reads as follow:

#### General Anti-Avoidance Rule

The Canadian Tax Act contains a general anti-avoidance rule which entitles Revenue Canada, Taxation to alter the tax consequences of certain transactions in order to deny a tax benefit resulting from the transactions. The rule will apply to a transaction that results, or that is part of a series of transactions that result, in a tax benefit unless the transaction may reasonably be considered to have been undertaken primarily for bona fide purposes other than to obtain the tax benefit, or it may reasonably be considered that the transaction would not result in a misuse of the provisions of the Canadian Tax Act or an abuse having regard to the provisions of the Canadian Tax Act read as a whole. The general anti-avoidance rule is a new provision which has not yet been the subject of judicial comment. Although the matter is not free of doubt, in the opinion of tax counsel to the Partnership [or Corporation, or other] the general anti-avoidance rule will not apply to deny any tax benefits to the Partnership ... as described in this summary. However, there is no



assurance that Revenue Canada, Taxation will not attempt to apply the general anti-avoidance rule to alter the tax consequences to the ...<sup>80</sup>

Subsection 245(4) seems to be the most troubling subsection for the tax practitioners. I believe that there may be two distinct, yet complementary, explanations for this trouble. First, the subsection "draws on the doctrine of abuse of rights".<sup>81</sup> Interestingly, the tax practitioners who have been the most vocal in criticizing GAAR are lawyers whose background is the common law. The discomfort of common law lawyers with the abuse of rights doctrine surfaces in relation with subsection 245(4). Common law lawyers just do not know, or do not want to know, how to deal with the doctrine. From their perspective, the abuse of a right is something that is simply impossible. Secondly, to the question "does abusive tax avoidance exist?", their answer is a definite "no". None of the tax lawyers interviewed believes that there is such a thing as abusive tax avoidance.<sup>82</sup> They mentioned that tax planning had become a second nature to them, and as far as they were concerned, the only question was whether the transactions were legal. To the extent that a transaction is legal, even if its legality rests only in a technical interpretation of the provisions of the *Act*, it is not abusive. If the Department of Finance does not like a transaction, it can act upon it.<sup>83</sup> It does not seem to have occurred to them that GAAR is a way to "act upon it". Interestingly, the same question was asked to non-

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<sup>80</sup> This typical "GAAR clause" has graciously been provided by Ross Tunnicliffe, *supra* note 73.

<sup>81</sup> Technical Notes, *supra* note 3 at 40,600.

<sup>82</sup> Telephone interview with W. A. Ruskin, *supra* note 71; Telephone interview with J. A. Nitikman, *supra* note 75; Telephone interview with H. J. Kellough, *supra* note 76. Although Mr. Kellough was the only one who had some difficulty in formulating his answer, it appeared from it that he too does not believe that there is such thing as abusive tax avoidance.

<sup>83</sup> Telephone interview with J. A. Nitikman, *ibid*.

tax lawyers and ordinary citizens, and the answer was totally the opposite.<sup>84</sup> Are tax lawyers wilfully blind to the issue of fairness in the taxation system?

If GAAR receives a very narrow judicial interpretation, one may wonder whether it will continue to have the same deterrent effect on tax planning practices. I think not.

#### **B. Doctrinal Law developed after the General Anti-Avoidance Rule**

After GAAR's enactment, some judicial trends have developed which permit one to extrapolate the interpretation to which GAAR will be subject. There is some strong evidence that the courts' interpretation of GAAR will not be favourable to the government.

Approximately one and one half years after GAAR's coming into force, the Tax Court of Canada, in *Orr v. M.N.R.*,<sup>85</sup> gave some valuable insights regarding the possible attitude of the courts towards the determination of the purpose of transactions, tax avoidance and tax planning in general. In that case, Alexander Orr Ltd., Mr. Orr's company, entered into a series of transactions with Mr. Orr's two sons which purported to rejuvenate its cumulative deduction account. The shares which had been transferred to the sons were repurchased by Mr. Orr's company before its fiscal year-end. Incidentally, the series also resulted in a reduction of the amount of tax payable by both the appellant, Mr. Orr, and its company. The Minister contended that the series was an abuse of the purpose of subsection 73(5) of the *Act* since its purpose "was to assist in passing a family business to the next generation".<sup>86</sup>

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<sup>84</sup> See: pp.148-149 below.

<sup>85</sup> [1989] 2 C.T.C. 2348, 89 D.T.C. 557 (T.C.C.) [hereinafter referred to as *Orr* cited to D.T.C.].

<sup>86</sup> *Ibid.* at 562.

With respect to the purpose of the subsection, Brulé T.C.J. held as follow:

In the present case there is no clear statutory prohibition to what the Appellant did. Parliament intended that shares be transferred to the family. This was done. Subsection 73(5) does not specify a time limit in which shares must be held ...<sup>87</sup>

Brulé T.C.J.'s understanding of the purpose of a transaction is very limited: "[p]arliament intended that shares be transferred to the family. This was done."<sup>88</sup> It does not seem to have occurred to him that the subsection 73(5) requirement that shares be transferred to the family is not the intention of the Parliament. The transfer of the shares to the family is a pre-requisite for the application of subsection 73(5), but that does not make it the purpose of the provision. I would qualify Brulé T.C.J.'s technique of interpretation as a hidden technique of strict construction, hidden because although he states that he analyses the transaction in light of the purpose of the *Act*, he does not in fact attempt to uncover the true purpose of the section. Such an approach to the Parliament's intent could certainly nullify the effect of subsection 245(4) as it would lead to a reasoning along the following lines:

- (a) Parliament intended that shares be transferred to the family;
- (b) this was done;
- (c) therefore, there is no misuse or abuse of the provisions of the *Act*.

This kind of reasoning would circumvent all together any policy analysis of the *Act*'s provisions.<sup>89</sup>

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<sup>87</sup> *Ibid.* at 566.

<sup>88</sup> *Ibid.*

<sup>89</sup> Unfortunately, this way of analyzing the underlying policy of the *Act*'s various sections is characteristic of tax decisions. In this regard see also: *Duha Printers (Western) Ltd. v. M.N.R.*, [1995] 1 C.T.C. 2481, 95 D.T.C. 828 (T.C.C.).

Brulé T.C.J. concluded his analysis on the following words:

It is difficult to establish a clear distinction between tax planning and tax avoidance. Tax avoidance may best be considered as a grey area between tax evasion and tax planning. Any plan should envisage finality and this was present in this case. At best one might say that what took place was a mischief not anticipated by the statute. Where the statute does not give a true picture and proper direction then the case law is looked at for guidance. Here we find this be *[sic]* referring to *Stubart*. Tax imposition is an administrative matter and the legislature must be relied upon to correct any defects or shortcomings. In the absence of a strict prohibition the taxpayer is entitled to arrange his affairs accordingly.<sup>90</sup>

What a great line for tax planners: "[a]t best one might say that what took place was a mischief not anticipated by the statute." Hopefully the courts will realize that GAAR was enacted as a remedy for these "mischiefs". Even relying on *Stubart*, the purposive interpretation of the *Act* has still a long way to go, and the question remains of what impact GAAR will really have.

Another case worth mentioning is *M.N.R. v. Irving Oil Ltd.*<sup>91</sup> In this case, Irving Oil Ltd. [hereinafter referred to as "Irving Oil"] interposed a Bermudian subsidiary, Irvcal, in the chain of acquisition of crude oil. Irvcal purchased the crude oil at cost from Socal, and sold it at fair market value to Irving Oil. The evidence showed that Irvcal was not part of the price negotiation, never took possession of the oil and never insured it. The Court recognized that this scheme was a mere tax device designed to "park" profits in Irvcal to distribute them later to Irving Oil in the form of non-taxable dividends. The Court nonetheless bluntly stated:

Be all that as it may, a transaction or arrangement does not fail effectively to avoid tax simply because it lacks a *bona fide* business purpose.<sup>92</sup>

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<sup>90</sup> *Ibid.* at 566 and 567.

<sup>91</sup> [1991] 1 C.T.C. 350, 91 D.T.C. 5106 (F.C.A.) [hereinafter referred to as *Irving Oil* cited to D.T.C.].

<sup>92</sup> *Ibid.* at 5112.

It then relied on *Stubart* to support its statement that a strict *bona fide* business purpose test could in fact jeopardize parliamentary intentions or economic policy objectives, and continued:

Parliament presumably had a policy objective, obviously unrelated to the raising of revenue in maintaining, until 1976, the deduction ...

[footnote: Persons interested at the time were very much aware that in the tax reform of 1972, it had been concluded that the exemption of dividends from foreign affiliates should be restricted to treaty situations and that the transitional exemption until 1976 was given to permit Canada to expand its network of tax treaties].<sup>93</sup>

The Court concluded that "the tax avoidance scheme contrived in the present case did not offend the Income Tax Act".<sup>94</sup>

In comparison to Brulé T.C.J. in *Orr* who refused to find the parliamentary intentions of a provision, the Federal Court of Appeal:

- (a) acknowledges existence and knowledge of the parliamentary intention;
- (b) acknowledged that *Stubart* rejects a strict business purpose test in favour of a more purposive approach; and
- (c) nonetheless, refuses to abide by it.

It appears that in reaching its conclusion, the Federal Court of Appeal did some editing of *Stubart*. Its influence on GAAR's interpretation therefore lies in how much "editing" of GAAR the courts will be able to do.

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<sup>93</sup> *Ibid.*

<sup>94</sup> *Ibid.* at 5114. Furthermore, in *M.N.R. v. Hoefele et al.*, [1995] 1 C.T.C. 2177, 95 D.T.C. 5602 (F.C.A.) at 5606, the court bluntly stated that there was nothing immoral about avoiding taxes:

And because form matters, one may structure one's affairs so as to minimize the tax payable on certain transactions. There is nothing wrong with this. Subject to provisions such as section 245, it is neither illegal or immoral. Some of the best legal minds in Canada are devoted exclusively to this enterprise.

In view of such statements, it is hard to imagine what could motivate Canadian judges to interpret GAAR liberally.

*Mark Resources Inc. v. M.N.R.*<sup>95</sup> involved the deductibility of interests paid on money borrowed for the purpose of utilizing in Canada losses of a U.S. subsidiary. Mark Resources Inc.'s predecessor, PDL, borrowed funds from the Royal Bank of Canada. PDL forwarded these funds as contributed capital to its U.S. subsidiary, PDI, which immediately invested the money in a term deposit with the Royal Bank as security for PDL's loan. With the interest earned, PDI utilized its accumulated U.S. losses and paid tax free dividends to PDL. PDI then cashed out the term deposit and lent it to PDL to repay its loan. PDL later liquidated PDI and sought deduction of the interest paid on the loan.

When asked to rule on the artificiality of this series of transactions, the Court commented:

It is fair to say that artificiality is in the eye of the beholder, and where one draws the line between "acceptable" and "unacceptable" tax avoidance schemes is a matter of perception. In that determination the fact that the scheme may have been predominantly or exclusively fiscally motivated plays a minor role or even a non-existent role. What is of far greater importance is whether the scheme falls within accepted norms of commercial reality.<sup>96</sup> [emphasis added]

In this passage, the Court takes a position on two points which may be crucial to the interpretation of GAAR. First, it rejects the relevance of fiscal motivation as a criterion of distinction between acceptable and unacceptable tax avoidance. If Bowman T.C.C.J. meant that "motive" is not a criterion upon which one can draw the distinction, I would agree. I do not believe, however, that that is what he meant. I believe that he confused both motive and purpose, and that he rejected the purpose of the transactions as a criterion of distinction between acceptable and unacceptable tax avoidance. With GAAR, certainly Bowman T.C.C.J. will be

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<sup>95</sup> 93 D.T.C. 1004 (T.C.C.) [hereinafter referred to as *Mark Resources* cited to D.T.C.].

<sup>96</sup> *Ibid.* at 1009.

unable to reject the purpose of a transaction so clearly. Nonetheless, the above words clearly demonstrate his feelings toward the purpose criterion, and surely Bowman T.C.C.J. will take every opportunity to widen the scope of the relieving portion of subsection 245(3) and subsection 245(4).

Secondly, he relied upon a commercial reality argument to reject the artificiality of the series of transactions. This kind of argument is insidious because it is always attractive but annihilates any efforts of rationalization of the Courts' conclusions. It is a teenager type of argument: it's O.K. mom, everyone does it! The fact that it is commercially accepted and common to engage into artificial tax avoidance activities can not be construed as a waiver of liabilities under the *Act*.

This kind of argument was first relied upon in *Stuart* by Estey J. to reject the application of the ineffective transactions doctrine. Since the doctrine has a very narrow scope of application, such an argument could have been relatively inoffensive had it been confined to it. Now that it has been extended to the artificiality of transactions, it may well become pervasive. Will commercial reality arguments have an impact on GAAR's interpretation? Could it be used to negate the misuse or abuse of the provisions of the *Act*? It should not, but I am afraid it could.

The Court's judgment in *Mark Resources* also has another interesting twist to it. Indeed, Bowman T.C.C.J. held that when it is faced with a series of transactions, "[e]ither the whole structure falls or it does not."<sup>97</sup> This goes completely against new section 245. I wonder whether the courts will also be able to annihilate the effect of the section.

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<sup>97</sup> *Ibid.* at 1010.

Approximately one year after *Mark Resources*, the issue of tax avoidance came up again before Bowman T.C.C.J. in *Continental Bank of Canada et al. v. M.N.N.*<sup>98</sup> Essentially, the facts are as follow:

(a) Continental Bank of Canada [hereinafter referred to as "CB"] was the parent of Continental Bank Leasing Corporation [hereinafter referred to as "CBL"];

(b) CB wanted CBL to sell its depreciated assets but also wanted to avoid recapture; and

(c) Central Capital Corporation [hereinafter referred to as "CC"] is the purchaser and was at first willing to buy CB's shares of CBL but the negotiations fell through. CC then offered CB to purchase CBL's assets only and the following tax scheme ensued:

(1) CB incorporated a new company which subsequently amalgamated with CBL to create a new year-end;

(2) CBL formed a partnership with two of CC's subsidiaries;

(3) CBL's assets were rolled into the partnership at UCC under subsection 97(2);

(4) CBL was wound up into CB; and

(5) CB sold the partnership interest to the two remaining partners thereby realizing approximately the same capital gain it would have realized had it sold the shares.

Revenue Canada reassessed CB on the basis of illegality, sham transactions and substance over form doctrines, agency, income versus capital gain and object and spirit of the provision. For our purposes, a review of the sham transactions doctrine and object and spirit arguments are sufficient.

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<sup>98</sup> [1995] 1 C.T.C. 2135, 94 D.T.C. 1858 (T.C.C.) [hereinafter referred to as *Continental Bank* cited to D.C.T.]. This case is presently under appeal.



I find Bowman T.C.C.J.'s discussion of the sham transactions doctrine interesting for two reasons. First, his comments about the various judicial anti-avoidance doctrines reveal a strong view that taxpayers' tax schemes should not be interfered with. He said:

In cases of this type expressions such as sham, cloak, alias, artificiality, incomplete transaction, simulacrum, unreasonableness, object and spirit, substance over form, bona fide business purpose, step transaction, tax avoidance scheme and, no doubt, other emotive and, in some cases, pejorative terms are bandied about with a certain abandon. Whatever they may add, if anything, to a rational analysis of the problem, apart from a touch of colour in an otherwise desiccated landscape, they do not exist in separate watertight compartments. They are all merely aspects of an attempt to articulate and to determine where "acceptable" tax planning stops and fiscal gimmickry starts.<sup>99</sup>

How the courts will, on this basis, deal with the subsection 245(3) primary non-tax purpose and the subsection 245(4) misuse or abuse remains to be seen. Obviously, the courts will not be able to repudiate legislative provisions. They may however interpret them very narrowly.

Secondly, and this is consistent with his finding in *Mark Resources*, Bowman T.C.C.J. denies that only a few transactions of a series can be excised from the sequence.<sup>100</sup> Certainly the argument will be appealing to tax planners, although they doubt its validity.<sup>101</sup> Again, I wonder whether the courts will invalidate the paragraphs of section 245 which refer to a series of transactions.

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<sup>99</sup> *Ibid.* at 1866, 1867.

<sup>100</sup> *Supra* note 97.

<sup>101</sup> Joel A. Nitikman, "Current Cases of Interest", *Report of the Proceedings of the Forty-Sixth Tax Conference* (1994 Conference Report), Toronto, C.T.F., 1995, 12:1-48, at 12:3:

The court also made the interesting and, I believe, unfounded argument that the minister must treat the entire structure as a sham or no part of it as a sham. Clearly, in a commercial transaction such as this one, certain parts will be real while others may be cobbled together to get at some specific tax advantage. Just why the minister cannot attack solely those parts of the deal is not clear. It is true, however, that the minister cannot call a part of the deal a sham for one purpose but real for another: either it is a sham or it is not.

I now turn to Bowman T.C.C.J.'s analysis of the object and spirit argument. His understanding of it is that:

[T]he rule of interpretation that requires a court to construe a statute in accordance with its object and spirit to mean simply this: the words of the statute are of course of primary importance, since it is through them that Parliament has expressed its intention. Nonetheless, an interpretation that in inconsistent with, or defeats, the obvious purpose of a provision is to be avoided unless the plain words compel a different interpretation.<sup>102</sup>

Is this really what Estey J. meant in *Stubart*? This may be a strong indication that the interpretation of the words "misuse or abuse" by implication will have to be based on some express indications in the *Act* that a particular transaction or series of transactions consist in a misuse or abuse of the provisions of the *Act*. This may also be the basis for a narrow interpretation of subsection 245(4), specially when one considers the interpretation that Bowman T.C.C.J. gave to subsection 97(2):

What, then, is the "object and spirit" of subsection 97(2)? ... its object seems rather straightforward. It is to permit a taxpayer to transfer assets to a partnership in return for a partnership interest without triggering the immediate tax result that such a transfer would normally entail. Tax is not avoided; it is deferred and the potential tax is preserved within the partnership until the assets are disposed of, ... That deferral is not obtained without a certain hidden cost. ... I do not see how a taxpayer who avails itself of that provision, with both its advantages and potential disadvantages, can be said to have acted in contravention of its object and spirit. In *Irving Oil* ... [t]he Federal Court of Appeal held ... that the tax avoidance scheme involved in that case "did not offend the Income Tax Act." If that scheme did not offend the Income Tax Act I would be hard pressed to see how this one did.<sup>103</sup>

It is plain from the last two sentences that a reassessment of this tax scheme under GAAR would not have been upheld by the Tax Court as it would be within the ambit of subsection 245(4). What, then, will GAAR apply to? This interpretation alone justifies the enactment of specific

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<sup>102</sup> *Continental Bank*, *supra* note 98 at 1872.

<sup>103</sup> *Ibid.* at 1872, 1873.

anti-avoidance provisions in addition to GAAR.<sup>104</sup> Can we expect a more liberal interpretation under GAAR because of its message? I do not believe so. No matter what message GAAR sends to the tax community, the strong feelings about tax avoidance are likely to remain unchanged and, in the end, they are the ones influencing the courts' decisions.

*Husky Oil Ltd. v. M.N.R.*<sup>105</sup> is relevant in that it may influence the judicial interpretation of subsection 245(1)'s definition of tax benefit. In that case, *Husky Oil Ltd.* [hereinafter referred to as "*Husky Oil*"] had realized a large capital gain which it wanted to offset. The tax schemes involved the acquisition of properties of unrelated corporations, which properties had inherent capital losses, and their winding up in *Husky Oil*. The issue before the Court was whether there had been a tax benefit for the purpose of former subsection 245(2). The issue turned upon the definition of "benefit" and was answered in the negative. Kempo T.C.J. held that no benefit can arise from an advantage obtained at fair market value.

If the courts apply this definition of "benefit" to GAAR, a tax benefit under subsection 245(1) will be understood as a "reduction, avoidance or deferral of tax or other amount payable ... or an increase in a refund or other amount receivable ..." <sup>106</sup> provided that such reduction or increase is not obtained through a bargaining at fair market value. According to J. A. Nitikman, this approach makes sense because "[i]f it were otherwise, every party to a good

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<sup>104</sup> See: pp.111-113 above.

<sup>105</sup> [1995] 1 C.T.C. 2184, 95 D.T.C. 316 (T.C.C.) [hereinafter referred to as *Husky Oil*]. *Husky Oil* was appealed by the Minister and the appeal dismissed. The reasoning of the Federal Court of Appeal to dismiss the appeal is even more insidious and circular than the reasoning of the Tax Court as it proclaims that the tax benefit was not conferred by anyone but the *Act*. See: *M.N.R. v. Husky Oil Ltd.*, [1995] 1 C.T.C. 460, 95 D.T.C. 5244 (F.C.A.) at 5246:

The tax refund obtained by the Respondent was a benefit. No one denies that. ... The respondent was either entitled or not to obtain the tax refund. If it was so entitled, that benefit was not conferred on the respondent by anyone but merely flowed from the provisions of the Income Tax Act ... [emphasis added]

<sup>106</sup> *Income Tax Act*, *supra* note 2, subsection 245(1).

bargain would be at risk."<sup>107</sup> Personally, I find this argument to be as insidious as the commercial reality one. What made this series of transactions unacceptable tax planning to the Minister is not that the shares were bought at fair market value, but the introduction of layers of corporate subsidiaries and consecutive transfers of the properties to assure this last transfer at fair market value. This series of transactions may not be as offending as the series in *Continental Bank*, but it is certainly more offensive than the series in *Stuart*. At least the series of transactions in *Stuart* resulted in the utilization of losses within one corporate family. This series of transactions resulted in the utilization of losses and off-setting of gains between unrelated corporations. Traditional business was about making money. As it is acknowledged that business may fluctuate from year to year, the government permits the carry back and forward of losses. Is modern business also about the commercialization of losses?

The following four cases, *Antosko et al. v. M.N.R.*,<sup>108</sup> *C.U.Q. v. Corp. Notre-Dame de Bon Secours*,<sup>109</sup> *Partagec Inc. v. C.U.Q.*<sup>110</sup> and *Buanderie centrale de Montréal v. Montréal (City of)*,<sup>111</sup> are all cases handed down by the Supreme Court of Canada concerning the interpretation of taxing statutes and are pertinent in interpreting subsection 245(4). The three latter cases are referred to as the Quebec trilogy.<sup>112</sup>

In *Antosko*, the Supreme Court held, after having cited *Stuart* with approval, that:

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<sup>107</sup> *Supra* note 101 at 12:3.

<sup>108</sup> [1994] 2 S.C.R. 312, [1994] 2 C.T.C. 25, 94 D.T.C. 6314 (S.C.C.) [hereinafter referred to as *Antosko* cited to D.T.C.].

<sup>109</sup> [1994] 3 S.C.R. 3, 95 D.T.C. 5017 (S.C.C.) [hereinafter referred to as *Notre-Dame* cited to D.T.C.].

<sup>110</sup> [1994] 3 S.C.R. 57 [hereinafter referred to as *Partagec*].

<sup>111</sup> [1994] 3 S.C.R. 29 [hereinafter referred to as *Buanderie centrale*].

<sup>112</sup> J. A. Nitikman, *supra* note 101 at 12:18.

While it is true that the courts must view discrete sections of the *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 are clear and plain and where the legal and practical effect of the transaction is undisputed. ... In this appeal despite conceding that these factual elements [conditions of application of the section in issue] are present, the respondent [minister] is asking the Court to examine and evaluate the transaction in and of itself, and to conclude that the transaction is somehow outside the scope of the section in issue. In the absence of evidence that the transaction was a sham or an abuse of the provisions of the Act, it is not the role of the court to determine whether the transaction in question is one which renders the taxpayer deserving of a deduction. If the terms of the section are met, the taxpayer may rely on it, and it is the option of Parliament specifically to preclude further reliance in such situations. ... Where the words of the section are not ambiguous, it is not for the Court to find that the appellants should be disentitled to a deduction because they do not deserve a "windfall" ...<sup>113</sup> [emphasis added].

It is obvious from the above excerpt that the Court does not want to compromise its status in tax avoidance cases: we will adopt a purposive approach in interpreting taxing statutes, but the purpose will have to be found solely on the basis of the bare words of the statute. Of course, in most situations the words of the taxing statute will be clear and unambiguous as they relate to particular facts; they are so because they are the product of policy decisions made to address *bona fide* transactions. Tax avoidance is just that, creating transactions which will fit within the clear, unambiguous and technical words of the sections in order to benefit from tax advantages designed for *bona fide* transactions. The sections of the *Act* are the result of the government's policy decisions based on the assumption that they will apply to transactions carried out in the normal course of business. Until the courts accept this fact, they will continue to hide behind a "purposive interpretation slogan" to protect tax avoiders. Courts should recognize that, in most cases, the "windfalls" are mere greedy opportunism. When the words of a section are

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<sup>113</sup> *Supra* note 108 at 6320, 6321.

clear, the purpose of the section is simply the answer to the following question: "to what *bona fide* situations are these clear words supposed to apply to?" Indisputably, if a taxpayer engages in a transaction for the sole purpose of avoiding taxes, the transaction can not be one of the *bona fide* situations contemplated by the section. I do not believe that this exercise requires stretching of the imagination, but if the courts refuse to submit themselves to this exercise, I do not know how they will ever find that there has been an abuse of a provision of the *Act*.

In the above excerpt, the Court also refers to its role in determining if a taxpayer deserves a deduction. One should not dramatize. There is a difference between adjudicating upon deservedness and recognizing abuse when it occurs. The Minister is not asking the court to determine whether taxpayers have done something that makes them deserve the benefit of a particular provision. The Minister is asking the courts to determine whether the taxpayers have done something that puts them outside the range of transactions envisaged by the section. In my view, the latter approach is a more limiting approach and not as repulsive as the former since it requires an action on the part of the taxpayer that will make him or her fall outside the realm of legitimate transactions. He or she would therefore not be left at the whim of the Minister.

This brings us to the Quebec trilogy. In these cases, the Supreme Court conceded once again that, by reason of the evolution of the *Act* from a mere revenue raising tool to a tool of economic and social policy, the traditional rule of strict construction of the taxing statutes was outdated and a more liberal approach should be adopted. This liberal approach "may be summarized as follows:

- (a) the interpretation of tax legislation should follow the ordinary rules of interpretation;

- (b) a legislative provision should be given a strict or liberal interpretation depending on the purpose underlying it, and that purpose must be identified in light of the context of the statute, its objective and the legislative intent: this is the teleological approach;
- (c) the teleological approach will favour the taxpayer or the tax department depending solely on the legislative provision in question, and not on the existence of predetermined presumptions;
- (d) substance should be given precedence over form, to the extent that this is consistent with the wording and objective of the statute;
- (e) only a reasonable doubt, not resolved by the ordinary rules of interpretation, will be settled by recourse to the residual presumption in favour of the taxpayer."<sup>114</sup>

The basis for these principles is that:

[i]n our time it has been recognized that such legislation [taxing legislation] serves other purposes and functions as a tool of economic and social policy. By submitting tax legislation to a teleological interpretation it can be seen that there is nothing to prevent a general policy of raising funds from being subject to a secondary policy of exempting social works. Both are legitimate purposes which equally embody the legislative intent and it is thus hard to see why one should take precedence over the other.<sup>115</sup>

The Supreme Court further specified that, according to the ordinary rules of interpretation, "the words of an *Act* are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the *Act*, the object to the *Act*, and the intention of Parliament.' The first consideration should therefore be to determine the

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<sup>114</sup> *Notre-Dame*, *supra* note 109 at 5023. This approach and principles were also applied in *Buanderie centrale* and *Partagec*.

<sup>115</sup> *Ibid.* at 5022.

purpose of the legislation, whether as a whole or as expressed in the particular provision."<sup>116</sup> Unfortunately, this only applies when there is ambiguity,<sup>117</sup> and only in a minority of cases.

The danger with the principles of interpretation of the taxing statutes as elaborated in the Quebec trilogy is that they are not tax avoidance cases. In these cases, the situation is the reverse of the situation which usually arises in tax avoidance cases: the taxing authority attempted to interpret its taxing statutes very formally so that the taxpayers would be denied the benefits which were intended to apply to their situations. Accordingly, the language used is very much in favour of the taxpayers. The same language will be used in tax avoidance cases to help tax avoiders who attempt to interpret the *Act* very formally so that they will be granted the benefits which were not intended to apply to their situations. No matter how well intended the Quebec trilogy was, it may have an adverse effect in GAAR cases.

Finally, there is *Michelin* which freely and openly applies GAAR. Deplorably, it is only a tribunal decision with no real binding or even persuasive authority, which tribunal did not even attempt to express its views on GAAR's implications.

Although there may be cases less antagonistic to the Minister's cause, clearly, in developing GAAR's jurisprudence, Revenue Canada officials face a tremendous challenge as non-interventionist feelings play against them,<sup>118</sup> the courts hide behind a false purposive approach and commercial reality,<sup>119</sup> the courts may not be willing to recognize the existence

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<sup>116</sup> *Ibid.*

<sup>117</sup> *Ibid.*

<sup>118</sup> *Mark Resources*, *supra* note 95; *Continental Bank*, *supra* note 98.

<sup>119</sup> *Mark Resources*, *ibid.*; *Continental Bank*, *ibid.*; *Orr*, *supra* note 85; *Irving Oil*, *supra* note 91; and *Antosko*, *supra* note 108.



of a benefit if the transaction is at fair market value,<sup>120</sup> and the courts may refuse to strike down single transactions which are part of a series of transactions.<sup>121</sup>

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<sup>120</sup> *Husky Oil*, *supra* note 105.

<sup>121</sup> *Mark Resources*, *supra* note 95; *Continental Bank*, *supra* note 98.

Apart from GAAR, tax avoidance is a very delicate issue. It has been extremely difficult for the courts to develop a coherent body of anti-avoidance jurisprudence either under former subsection 245(1) or through judicial doctrines. Indeed, this difficulty is one of the policy considerations which warranted the enactment of a general provision to deal with tax avoidance, and led to GAAR. To date, GAAR has had some deterrent effect on tax planning practices. However, this effect could disappear over time as neither the Department of Finance nor the courts seem to know how to handle tax avoidance, let alone GAAR. As previously discussed, the Department of Finance seems to favour a paternalistic approach in applying GAAR and the courts abide by a non-interventionist attitude. This combination will probably serve to narrow the scope of GAAR, thereby removing its surrounding uncertainty and its deterrent effect.

In this Chapter, I shall discuss the effectiveness and effect of GAAR. I shall address how GAAR should be approached by the Department of Finance and interpreted by the courts, and demonstrate why GAAR, or any other legal measure for the same purpose, is not likely to change the face of tax avoidance in Canada.

#### **A. Effectiveness of the General Anti-Avoidance Rule**

In this part, I shall consider whether some amendments to GAAR, adjustments to both the Department of Finance's and the courts' approach to GAAR, and provision of new interpretative tools to the courts, could maximize GAAR's effectiveness.

## 1. Amending GAAR

At a technical level, the organization of the different subsections of GAAR is awkward. It is nothing that a quick mental gymnastic exercise cannot overcome, but if confusion could be prevented, effectiveness could be maximized.

First, GAAR's charging provision, subsection 245(2), relies on three other provisions to reveal its full meaning: subsections 245(1), (3) and 248(10) of the *Act*. Reference to subsection 248(10) to define "series of transactions" is justifiable as the phrase is not specific to section 245. However, reference to subsections 245(1) and (3) to define phrases which are specific to section 245 is unnecessarily disruptive. As mentioned above, it is not an impossible intellectual exercise to read conjunctively all three subsections 245(1), (2) and (3) in order to grasp the plain meaning of subsection 245(2). GAAR would nonetheless read more easily, had all the definitions been grouped in subsection 245(1). This would also have been in accordance with the general pattern of the *Act* which is first, to state the relevant definitions and, then elaborate on the substance.<sup>1</sup>

A second anomaly in GAAR's construction is subsection 245(4). What is subsection 245(4) exactly? How should it be construed in relation with subsection 245(3)? If, on the one hand, subsection 245(4) was intended to refine or perfect the definition of "avoidance transactions" found in subsection 245(3), it should be incorporated into it. If, on the other hand, subsection 245(4) was intended to relieve those transactions falling within its scope from the legal consequences otherwise flowing from the application of GAAR, it should remain intact.

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<sup>1</sup> In this regard, see: sections and subsections 54, 89 and 95, and 110.6(1), 147.1(1) and 149.1(1) which thoroughly embody the definitions relevant to either a particular section or subdivision of the *Act*.

According to the technical notes, "[n]ew subsection 245(4) of the *Act* contains an important limitation to the application of section 245."<sup>2</sup>

I understand this statement as confirming the latter hypothesis of subsection 245(4)'s construction. This construction is also a logical one. Indeed, it makes perfect sense that if a transaction, or series of transactions, is entered into with the purpose of the avoidance of taxes, it is considered *prima facie* as an avoidance transaction. It is only when transactions are entered into for non-tax purposes that they should be readily dismissed for want of meeting the threshold requirement of tax avoidance.<sup>3</sup> The fallacy about subsection 245(4)'s construction arises both because subsection 245(3) has been misplaced to begin with and should be part of the definition subsection, 245(1), and because subsection 245(4) is held to be "for greater certainty".<sup>4</sup> Subsection 245(4) is not "for greater certainty", it is a limitation to the application of GAAR. Its introductory clause adds nothing to it and should be removed.

At a substantive level, the requirement that transactions have a primary non-tax purpose, and the tax treatment of a series of transactions are also contestable. It has been suggested that, in light of the commercial reality argument put forward by the courts in recent cases, the requirement of a primary non-tax purpose should be removed and replaced by the requirement of a reasonably credible non-tax purpose.<sup>5</sup> This suggestion is the result of a calculated and tactical response to the courts' attitude towards tax avoidance; since the courts have adopted a

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<sup>2</sup> Canada, Department of Finance, *Technical Notes to Bill C-139 (Royal Assent, September 13, 1988)* (Don Mills, Ontario: CCH, 1989) at 40,599.

<sup>3</sup> *Income Tax Act*, R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63, and as subsequently amended, subsection 245(3).

<sup>4</sup> *Income Tax Act*, *ibid.*, subsection 245(4).

<sup>5</sup> See: p.97 above.

pro-taxpayer attitude,<sup>6</sup> one has to be careful not to put the courts in a position where they could negate the effect of subsection 245(4). Indeed, according to this pro-taxpayer trend of interpretation, a transaction that does not have a primary non-tax purpose, but a reasonably credible non-tax purpose, would probably be viewed favourably by the courts. Because the courts would not be able to salvage the transaction on the basis of subsection 245(3), they would likely do so on the basis of subsection 245(4). Such a result can only be achieved by narrowing its scope of application. Evidently, this narrow scope of application would not only be enforced in cases where the transaction has a reasonably credible non-tax purpose, but also in cases where it has no non-tax purpose. The overall result would be that GAAR would apply in an even lesser number of cases. So much for effectiveness!

Consequently, if the Department of Finance has any ambition to see subsection 245(4) receive an effective interpretation, it should give the courts some latitude in subsection 245(3). Moreover, some latitude in subsection 245(3) would reflect modern socio-economic realities. I do not believe that one can change the fact that tax planning has become part of doing business. Tax planning in that sense is about cutting back on expenses, taxes being one (there is a nuance, however, between having tax planning as part of doing business and having business as part of tax planning). Because the fact that tax planning has become part of conducting

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<sup>6</sup> See e.g.: *Indalex Ltd. v. M.N.R.*, [1986] 2 C.T.C. 482, 86 D.T.C. 6039 (F.C.T.D.); *M.N.R. v. Irving Oil Ltd.*, [1991] 1 C.T.C. 350, 91 D.T.C. 5106 (F.C.A.); *Spur Oil Ltd. v. M.N.R.*, [1981] C.T.C. 336, 81 D.T.C. 5168 (F.C.A.); *Stubart Investments Limited v. M.N.R.*, [1984] 1 S.C.R. 536, [1984] C.T.C. 294, 84 D.T.C. 6305 (S.C.C.).

See also: *454538 Ontario Ltd. v. M.N.R.*, [1993] 1 C.T.C. 2746, 93 D.T.C. 427 (T.C.C.); *Antosko v. M.N.R.*, [1994] 2 S.C.R. 312, [1994] 2 C.T.C. 25, 94 D.T.C. 6314 (S.C.C.); *Buanderie centrale de Montréal v. Montréal (City of)*, [1994] 3 S.C.R. 29; *C.U.Q. v. Notre-Dame de Bon Secours*, [1994] 3 S.C.R. 3, 95 D.T.C. 5017 (S.C.C.); *Continental Bank of Canada et al. v. M.N.R.*, [1995] 1 C.T.C. 2135, 94 D.T.C. 1858 (T.C.C.); *C.P.L. Holdings Ltd. v. M.N.R.*, 95 D.T.C. 5253 (F.C.T.D.); *Husky Oil Ltd. v. M.N.R.*, [1995] 1 C.T.C. 2184, 95 D.T.C. 316 (T.C.C.); *Mark Resources Inc. v. M.N.R.*, 93 D.T.C. 1004 (T.C.C.); *Orr v. M.N.R.*, [1989] 2 C.T.C. 2348, 89 D.T.C. 557 (T.C.C.); *Partagec Inc. v. C.U.Q.*, [1994] 3 S.C.R. 57; and their discussion, see: pp.118-133 above.

business cannot be changed, the legislator should recognize that fact and adapt subsection 245(3) to it to increase the subsection effectiveness.

With respect to the tax treatment of series of transactions, I only reiterate a point already made that the requirement that each step of the series must have a non-tax purpose is an overkill: one can not see the forest for the trees.<sup>7</sup>

A transposition of the above technical and substantive suggestions in the existing GAAR would lead to a new GAAR reading as follows:

**245.(1) Definitions.** -- In this section and in subsection 152(1.11),  
**"avoidance transaction".** -- an avoidance transaction means any transaction

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged for bona fide purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the series may reasonably be considered to have been undertaken or arranged for bona fide purposes other than to obtain the tax benefit;

**"tax benefit".** -- "tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act;

**"tax consequences".** -- "tax consequences" to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount;

**"transaction".** -- "transaction" includes an arrangement or event.

**(2) General anti-avoidance provision.** -- Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

**(3) Provision not applicable.** -- Subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction

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<sup>7</sup> See: pp.98-100 above.

would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

...

As GAAR is not worded in this way, I suspect that ways to get around the tax treatment of the series of transactions will be "big business". The one way which, I believe, could be successful in court is that even if a transaction in a series does not have a non-tax purpose, because it is part of a series of transactions which has an overall non-tax purpose, that transaction does not constitute a misuse or abuse of the provisions of the *Act*. The danger with this argument is that, if accepted, the courts could render paragraph 245(3)(b) of no force and no effect. It is not for the courts to second-guess the legislator's intent. Both the Technical Notes and the Information Circulars are silent on the Minister's position in such cases.

## 2. Adjusting the Minister's Approach to GAAR

Regardless of whether the Minister is dealing with GAAR or with its proposed new version, he should not second-guess his work. He should not stand by the paternalistic attitude adopted in the examples given in the Information Circulars,<sup>8</sup> or suggested by Mr. McDonnell,<sup>9</sup> rather he should be more assertive. Any approach whereby the Minister guarantees the

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<sup>8</sup> *Information Circular 88-2*, General Anti-Avoidance Rule Section 245 of the *Income Tax Act*, dated October 21, 1988; *Information Circular 88-2, Supplement 1*, General Anti-Avoidance Rule, dated July 13, 1990.

<sup>9</sup> Thomas E. McDonnell, "Legislative Anti-Avoidance: the Interaction of the New General Rule and Representative Specific Rules", *Report of the Proceedings of the Fortieth Tax Conference* (1988 Conference Report), Toronto, C.T.F., 1989, 6:1-34.

taxpayers that in a specific set of circumstances GAAR will not apply is paternalistic,<sup>10</sup> and it brings us back full circle to the problems engendered by specific anti-avoidance rules.<sup>11</sup>

I believe GAAR to be flexible enough not to require a rule of thumb to monitor its application. GAAR's application should monitor its own application.<sup>12</sup> A change in the paternalistic attitude of the Minister for a more assertive and rational one would have the following advantages:

- (a) it would result in a more coherent application of GAAR as a paternalistic approach does not demand the same rigidity in reasoning as an assertive and rational approach does; and
- (b) the coherence in application could probably be preserved because rationality needs to be explained, and it would therefore be more likely that the officials have access and recourse to an internal body of authorities.

At an internal level, Revenue Canada's officials have possibly adopted a rational and assertive approach since an "in-house" procedure to deal with GAAR cases has been

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<sup>10</sup> See e.g.: *Information Circular*, *ibid.* paragraphs 7, 8, 11, 13, 16 and 18; *Information Circular Supplement*, *ibid.* paragraphs 3 and 5.

<sup>11</sup> See: p.61 above.

<sup>12</sup> See: pp.106-112 above.

Because GAAR's application should monitor its own application, I suggest that the Minister should be more assertive and rational in his approach to GAAR. "Assertive" means that he should be confident that the rule is a good thing. It was the product of a long analysis and was carefully drafted. Accordingly, the Minister should not, as he does in his Information Circulars, state that in any given set of circumstances the rule will not apply. This is where the rational approach comes into play. In applying GAAR to offensive transactions, the Minister should go through each step of the rule:

- (a) is there a tax benefit?
- (b) was the transaction, or series of transactions, undertaken for some non-tax purpose?
- (c) is the transaction, or series of transactions, a misuse or abuse of the *Act*?

That is the assertive and rational approach.



established.<sup>13</sup> However, this attitude is not reflected in all public documents such as the Information Circulars. Because the courts ultimately decide on the application of GAAR, and because the courts have adopted a pro-taxpayers tendency, it would be important that the Minister send not only a clear message to the taxpayers that he does not accept abusive tax avoidance, but also to the courts that he is not delighted with the way they have been handling tax avoidance cases. After all, in our country, the Parliament is supposed to make the laws.

Indirectly, and because I suspect that in most cases the non-tax purpose requirement will not be met, the judicial debate will turn upon the applicability of subsection 245(4). In these cases, a rational application of GAAR will force the Minister to an in-depth analysis of the provisions of the *Act*, their rationale and their interrelations.<sup>14</sup> As mentioned above, this exercise alone could lead to a coherent and logical application of GAAR, if not to a maximized effectiveness of it. Also, possibly, this analysis of the *Act* at large could disclose and explain existing deficiencies and even result in changes.

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<sup>13</sup> Claude Désy, ed., *The Access Letter*, vol.5, no.10 (Montréal: Dacfo, Looseleaf) at 372. The internal procedure established works as follow:

The Tax Services Office's tax avoidance section, once they believe they may have a GAAR issue in their case, are to forward the facts of the case as known at that time for a preliminary comment by the GAAR committee as to whether or not the GAAR may apply to the transactions. When the audit is completed and they are still of the view that GAAR applies, they forward the facts, key documents and their comments to avoidance services at headquarters. We review the case, add our comments and forward the case to the GAAR committee.

The committee decides to either support the position, reject it or may ask for further information or clarification. If the committee concurs with the position, a proposal letter will be sent to the taxpayer/representative.

<sup>14</sup> I believe that the courts' attitude to be the direct factor forcing, or, at least, strongly warranting, an in-depth analysis of the provisions of the *Act*, and that even if the Minister's attitude remains unchanged, such analysis will still have to take place.

### 3. Adjusting the Courts' Approach to GAAR

The courts also have a responsibility to make GAAR effective. Recently, the courts have adopted a very pro-taxpayer attitude which, incidentally, coincides with the growth of tax expenditures in the taxation system.<sup>15</sup> I do not have definitive knowledge of the sociological reasons which warranted such a change. It is relatively easy, however, to speculate about those:

(a) Howard J. Kellough mentioned that the Federal Court of Appeal was less favourable to the taxpayers because most judges composing it were "ex-Revenue Canada" counsel, while the Tax Court is mostly composed of "ex-practitioners";<sup>16</sup>

(b) some facts irrelevant to the decision making process also play a role. In *Continental Bank of Canada et al. v. M.N.R.*<sup>17</sup> for example, what was the influence of the aborted sale of the shares?<sup>18</sup> What ever happened with the principle that taxpayers ought to be taxed according to what they did and not according to what they could have done?<sup>19</sup>

This principle must be reciprocal to both the taxing authorities and the taxpayers;

(c) there may be a fear that a hard line approach to tax avoidance will lead people to locating their businesses outside Canada, that foreigners will no longer do business in Canada, and there may also be a desire to even out the *rapport de force* between the "poor" taxpayers and the taxing authorities. With respect, regardless of how frightening

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<sup>15</sup> See: Neil Bruce, "Pathways to Tax Expenditures: A Survey of Conceptual Issues and Controversies" (The 7th John Deutsch Roundtable on Economic Policy, 1988) 21.

<sup>16</sup> Telephone interview with Howard J. Kellough, *Fraser & Beatty, Barristers & Solicitors* (July 1995) Vancouver. Seemingly the "ex-practitioners" do not get promoted if they import their practice in Ottawa.

<sup>17</sup> [1995] 1 C.T.C. 2135, 94 D.T.C. 1858 (T.C.C.).

<sup>18</sup> See: p.124 above.

<sup>19</sup> *I.R.C. v. Westminster (Duke)*, [1936] A.C. 3 (H.L.); *Stubart*, *supra* note 6.

and legitimate these hypotheses may be, it is not the role of the courts to address such concerns.

Certainly, it would be much easier to administer the taxation system if the courts were willing to work with the legislator to uphold the *Act*, I also believe that it would save the taxation system from much procrastination and would further its healthy evolution. Indeed, this persistent refusal by the courts to sanction tax avoidance, perhaps to protect taxpayers, yield to other and some deeper problems such as:

- (a) legitimizing class discrimination, because the courts ignore the fact that the relief of one's tax burden must automatically shifted over to somebody else, refuse to recognize that some tax planning can result in abusive tax avoidance, and because they refuse to recognize that this luxury is mainly the jewel of the wealthy;
- (b) thwarting the evolution of the Canadian taxation system, because the courts refuse to recognize that some tax planning can result in abusive tax avoidance and, accordingly, refuse to examine the validity of legislative provisions;
- (c) forcing an incoherent discourse on the Revenue's officials which, in turn, creates uncertainty and reinforces the perception that the system is unfair, because the courts refuse to give effect to the legislator's intent.

The courts have to understand the policy implications and objectives that the government is carrying out in the *Act* insofar as it is required to give effect to subsection 245(4). They have to apply the law as it has been enacted by the Parliament. This involves doing just a little more than simply stating that the *Act* has evolved into something more than a mere revenue-raising instrument,<sup>20</sup> and integrating the plain meaning of this "slogan" in their decision. It is only

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<sup>20</sup> *Stuart*, *supra* note 6; *C.U.Q. v. Notre-Dame de Bon Secours*, [1994] 3 S.C.R. 3, 95 D.T.C. 5017 (S.C.C.).

when the courts adopt this attitude that a dialogue between the people, them and the Department of Finance can take place and set some basis for a constant evolution and development of taxation law.

#### 4. Providing the Courts with Interpretive Tools

Traditionally, extrinsic evidence has been excluded from the court room.<sup>21</sup> More recently, however, the courts have been more inclined to admit such evidence.<sup>22</sup> The issue of admission of extrinsic evidence in tax cases, in light of subsection 245(4) of the *Act*, should receive renewed attention. Indeed, subsection 245(4) safeguards a transaction from a denial of its tax benefit when "the transaction [does] not result directly or indirectly in a misuse of the provisions of [the] Act or an abuse having regard to the provisions of [the] Act, other than this section[section 245], read as a whole."<sup>23</sup> The Technical Notes explains that "[w]here a taxpayer carries out transactions primarily in order to obtain, through the application of specific provisions of the *Act*, a tax benefit that is not intended by such provisions and by the Act read as a whole, section 245 should apply."<sup>24</sup> [emphasis added] Accordingly, subsection 245(4)'s safeguard turns upon the intention of the provisions which can sometimes best be determined by having recourse to extrinsic evidence.

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<sup>21</sup> *Millar v. Taylor* (1769), 98 E.R. 201; *Hill v. Dexter*, [1902] A.C. 474 (H.L.).

<sup>22</sup> See: *Pepper v. Hart*, [1993] A.C. 593, [1992] 3 W.L.R. 1032; *Symes v. M.N.R.*, [1993] 4 S.C.R. 695, 94 D.T.C. 6001 (S.C.C.); *Thibaudeau v. M.N.R.*, [1995] 2 S.C.R. 627, [1995] 1 C.T.C. 382, 95 D.T.C. 5273 (S.C.C.); *Central Supply Company (1972) et al. v. M.N.R.*, 95 D.T.C. 434 (T.C.C.).

<sup>23</sup> *Income Tax Act*, *supra* note 3, subsection 245(4).

<sup>24</sup> Technical Notes, at 40,600.

In the context of the *Act*, extrinsic evidence can be found in advance tax rulings, information circulars, interpretation bulletins, technical notes and parliamentary debates. It is well established that the information contained in the information circulars and interpretation bulletins is not binding upon Revenue Canada, but is rather intended to offer guidelines of Revenue Canada's current approach and policies regarding tax transactions. The publication of the advance tax rulings also bears the same intention, except that they are binding upon the parties. In what circumstances should parliamentary debates and, or technical notes be admissible as evidence? and to what extent?

The technical notes can be differentiated from the advance tax rulings, interpretation bulletins and information circulars in that they do not specify whether a section will, or will not, apply in particular cases. Technical notes focus more on the intention of the legislator than on specific cases and they reveal the purpose for which the statutory provisions are intended.<sup>25</sup> As such, they are usually of a general nature and do not yield the creation of new loopholes. If, however, they become too general, they may not add anything to the legislative text, except confusion. Just as any other form of evidence, technical notes should be admissible only if pertinent. On this basis, technical notes which are so general that they do not add anything to the legislative text, should be rejected for want of pertinence.

The same reasoning applies to parliamentary debates. Chances are, however, that they be more specific by reason of their very unique formation. They are indeed the products of an on-going parliamentary discussion which allows some kind of dialogue to be established, precise

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<sup>25</sup> Taking the technical notes relating to GAAR as an example, one will find expressions such as: "... the new rule seeks ...", " ... the wording of the new provision is intended ...". Technical Notes, *supra* note 2 at 40,597 to 40,603.

question to be asked and answered. Accordingly, they may be admissible as evidence on a more frequent basis, provided that they also are pertinent parliamentary debates.

The Canadian taxation system is based on voluntary compliance. A corollary of this characteristic should be that all Canadian income taxpayers know what rules they are subject to, which corollary is substantiated by the policy goal of simplicity. One only has to read a few sections of the *Act* to realize that this corollary is in no way fulfilled. Based on the premise that the corollary is not fulfilled, one's reasoning can go two ways:

- (a) one can argue that if the basic premise is not even fulfilled, the understanding of the *Act* should not be rendered more complex, and the principle of voluntary compliance jeopardized, further by resorting to extrinsic evidence; or
- (b) one can argue that since the basic premise is not already fulfilled, and the reading of the *Act* is also already rendered more complex by an abundant body of jurisprudence, recourse to extrinsic evidence would only have a minor impact on the principle of voluntary compliance.

Albeit the latter argument is more misanthropic and the former more paternalistic, both arguments are valid. The former argument also relates to an argument that "[t]he health of the law is determined by the number of people who can avoid going into court. Citizens and their lawyers should be able to rely on an apparently unambiguous statute in settling legal disputes without making further inquiries".<sup>26</sup> One should be reminded however that the issue of the admission of extrinsic evidence is analyzed in the context of GAAR which was enacted in response to highly technical tax avoidance schemes. It is probably fair to say that, in such cases, tax specialists or, at least, those who are tax cognizant, will be involved in the transaction

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<sup>26</sup> Gordon Bale, "Parliamentary Debates and Statutory Interpretation: Switching on the Light or Rummaging in the Ashcans of the Legislative Process", (1995) 74 Can. Bar Rev. 1-28, at 28.

which presupposes that they have a good understanding of the *Act* and a good knowledge of what tax monies are owed. In such a case, the first argument therefore fails.

In this discussion about the admission of extrinsic evidence in GAAR cases, one should be reminded that the discussion arises in the context of subsection 245(4) which specifically refers to the words "misuse" and "abuse". It is thus with these specific words in mind that, subject to my above comments, extrinsic evidence in GAAR cases should be excluded or admitted. The *Oxford Dictionary*<sup>27</sup> gives the following definitions of "use", "misuse" and "abuse":

**use** --*n.* 1 application to a purpose;<sup>28</sup>

**misuse** --*n.* 1 wrong or improper use or application;<sup>29</sup> and

**abuse** --*n.* 1 incorrect or improper use.<sup>30</sup>

These are words which refer to the purpose of the thing being used. Against these definitions, I suggest that the wording of the provisions of the *Act*, even if clear and unambiguous, does not reveal the purpose of their application but only the conditions. Based on this premise, one should therefore conclude that subsection 245(4) itself commands the admission of extrinsic evidence in GAAR cases.

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<sup>27</sup> R. E. Allen, ed., *The Concise Oxford Dictionary of current English*, 8th ed. (New York: Oxford University Press, 1990).

<sup>28</sup> *Ibid.* at 1352.

<sup>29</sup> *Ibid.* at 760.

<sup>30</sup> *Ibid.* at 6.

## B. Effect of the General Anti-Avoidance Rule on Tax Avoidance

Even if one assumes that GAAR is amended, that the Minister has adopted an assertive and rational attitude in applying GAAR, that the courts have adopted an unbiased approach to tax avoidance cases and that extrinsic evidence is admitted for the purpose of giving effect to subsection 245(4), one may question what the effect of GAAR on tax avoidance will be. Is GAAR, as it exists now, or as it exist in the above scenario, likely to revolutionize the highly technical tax avoidance that takes place in today's transactions?

As discussed, interviews with tax practitioners reveal that GAAR has not revolutionized their practice, but simply added another facet to it.<sup>31</sup> The interviews also reveal that for some of their clients, GAAR is only another "calculated business risk".<sup>32</sup> The interviews finally reveal that all of the tax practitioners refuse to admit that there is such thing as abusive tax avoidance.<sup>33</sup> They did not confess, however, that this is the product of wilful blindness. Certainly, GAAR has had one effect on them, it has made them very upset about it. There is one thing, however, that GAAR has not done and that is to force them to an introspection about the social consequences of tax avoidance. Have they become impassive over time?

Outside the sphere of tax professionals,<sup>34</sup> everyone seems to agree that there is such thing as a fair tax share, although everyone also specifies in the same breath that they do not pay

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<sup>31</sup> See: p.114 above.

<sup>32</sup> See: pp.114-115 above.

<sup>33</sup> E.g.: Telephone interview with William A. Ruskin, *Clark Wilson, Barristers & Solicitors* (July 1995) Vancouver; Telephone interview with Joel A. Nitikman, *Fraser & Beatty, Barristers & Solicitors* (July 1995) Vancouver; Telephone interview with Howard J. Kellough, *Fraser & Beatty, Barristers & Solicitors* (July 1995) Vancouver.

<sup>34</sup> Outside the sphere of tax professionals, I interviewed a few number of people of different livelihoods. These livelihoods include the following: stock broker, corporate investor, professional cook, self-employed real estate agent, self-employed consultant, waiter and Crown counsel.



their fair share, but more. Everyone also seems to agree that there is such a thing as abusive tax avoidance. In the course of my enquiry, some people gave examples of what they considered to be abusive tax avoidance. One example given was all the tax planning that evolved around the defunct research tax credit.<sup>35</sup> Another example related to the tax planning evolving around avoidance of the GST.<sup>36</sup> One person even gave me his own definition of what constituted tax avoidance: technical use of the tax provisions in disregard of their purpose.<sup>37</sup> Although there is consensus about the existence of abusive tax avoidance, there is also consensus that if one had the opportunity, one would abusively avoid taxes.

From the moment everyone says: "if I could, I would," the potential effect of GAAR on tax avoidance practices greatly diminishes because there will always be loopholes in the *Act*, there will always be ways to forge a non-tax purpose, there will always be intelligent lawyers to put forward some kind of pervasive argument and there will always be one judge who does not feel so strongly about tax avoidance to set a precedent that opens the door to arguments in favour of a certain leniency towards tax avoidance.

Tax avoidance is generally socially accepted. Generally, if one knows someone else who openly manipulates the provisions of the *Act* to his or her own benefit, unless it is Paul Martin's family, one will usually approve. One will also ask him or her how to achieve the same results. My personal experience has demonstrated that tax avoidance is a highly praised luxury: everyone who has learnt that I orient my career towards taxation law, has asked for the business card I do not have.

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<sup>35</sup> Telephone interview with Mark Sandercombe, *Canaccord Capital Corporation*, Stock Broker and Corporate Investor (July 1995) Vancouver.

<sup>36</sup> Interview with Marco Borck, Self-Employed Real Estate Agent (July 1995) Vancouver.

<sup>37</sup> Interview with Crown Counsel (July 1995) Vancouver.

As opposed to what the Reform documents led to believe,<sup>38</sup> clearly, tax avoidance is not rooted in legal schemes or legislative provision, tax avoidance is rooted in social behaviour.

Stemming from these observations, is the question of why tax avoidance is so highly praised. The responses I received echoed the determinants of tax compliance examined in Chapter Two:<sup>39</sup>

- (a) I pay more than I get back, this response relates to the lack of efficiency of the governments;
- (b) I do not want to give "them" my money because they do not know how to administrate it, this one relates to the perception of a wasteful government;
- (c) I do not know where my money goes, which relates to the accountability of the government; and
- (d) "they" are richer than I am and all "they" do is to put the money in their pocket, which relates both to the perception of unfairness and strong aversion to the government's spending.

These answers however are not about tax avoidance, they are about political convictions. Tax avoidance and political convictions are two distinct concepts. Tax avoidance is about harming other taxpayers by shifting over your own tax burden to them. Political convictions are about demanding the government to fulfil its mandate and be accountable for it. Today, tax avoidance is justified with political convictions. It should not be, but it is not likely to be changed as it would not be consistent with human nature: human nature does not address problems but finds

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<sup>38</sup> See e.g.: Canada, Department of Finance, *The White Paper on Tax Reform 1987 by the Honourable Michael H. Wilson Minister of Finance* (Ottawa: Department of Finance, on June 18, 1987); Canada, Department of Finance, *Income Tax Reform by the Honourable Michael H. Wilson Minister of Finance* (Ottawa: Department of Finance, on June 18, 1987).

<sup>39</sup> *Supra* notes 30, 31, 32 and 33 in Chapter Two, and accompanying text.

ways around it. Tax avoidance is one of those ways. The onus is on the government to acknowledge this problem and go counter to nature in addressing it.

GAAR certainly does not address this problem and this is why it has not and will not change the face of tax avoidance. Moreover, I suggest that no legislative provisions could ever address this problem in its entirety.

Perhaps, the answer would lie in doing some more comparative law. This time, however, the study should go outside the usual realm of nations considered,<sup>40</sup> to Ghana where there exist no such thing legislatively recognized as tax avoidance. In Ghana, there is a taxing statute in which one may organize his or her affairs and, outside this realm, there is tax evasion. Just how far one can go in organizing his or her affairs are social and moral issues.

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<sup>40</sup> These nations include the well known United Kingdom, United States, New Zealand and Australia.

## CONCLUSION

By entering upon the Tax Reform of 1987, the Department of Finance recognized tax avoidance as being a pressing problem in the Canadian taxation system rooted both in the legal sphere, as a result of the presence of tax incentives in the *Act*, and in social behaviour. The Department of Finance addressed this problem in the course of the Reform. It gave the issue what seems to be a great deal of thought, and came up with GAAR which is, despite some deficiencies, a legally good rule.

Nonetheless, since GAAR, the Canadian taxation system has remained pretty much the same. The *Act* still contains a multitude of specific anti-avoidance rules, albeit capped with a general one; tax expenditure programs are still part of the system; taxpayers are as eager as before to save tax monies even if it means unfairness to others; tax practitioners and judges have not proceeded to an introspection about the socio-economic effects of tax avoidance and they seem determined to nullify GAAR's impact as much as possible.

Has the Department of Finance really explored every possible alternative? Probably it has. The Department of Finance has tried in every way and with little success to limit meaningfully the use of the tax incentives to their purpose. It is now obvious that a solution to the problem of tax avoidance will not come from the *Act* or the courts, unless the Department of Finance educates judges about GAAR, in which case one could raise the issue of the independence of the judiciary. I believe that tax avoidance in Canada has reached a point beyond the sphere of competence of legal analysis within the actual framework of the *Act*.<sup>1</sup>

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<sup>1</sup> In light of this conclusion, I foresee that the topic of my next thesis will be about finding a solution to the problem of tax avoidance which would lie outside the actual framework of the *Act*. In this regard, one may suggest that the Department of Finance should review the current system of delivery of tax subsidies through tax expenditures analysis, as, clearly, there is a relation between such delivery and tax avoidance. Tax expenditure

(continued...)

Moreover, it is improbable that the Department of Finance will have any influence on social behaviour.

In light of all this I ask: "Has GAAR changed the face of tax avoidance?" Unfortunately, I must answer: "No it has not, and, until GAAR is supported by socially influential devices, it will not." GAAR has simply modified the way taxpayers may reduce their tax liability and limited the class of people who can avail themselves of the benefits of tax avoidance. This negates completely one of the main objectives of the Reform; that is fairness.

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<sup>1</sup>(...continued)

analysis has, however, already been the subject of much debate. In this regard see: A. Premchand, *Government Budgeting and Expenditure Controls: Theory and Practice* (Washington, D.C.: International Monetary Fund, 1983); Neil Bruce, "Pathways to Tax Expenditures: a Survey of Conceptual Issue and controversies" (The 7th John Deutsch Roundtable on Economic Policy, 1988) 21; Jonathan Kesselman, "Direct Expenditures versus Tax Expenditures for Economic and Social Policy" (The 7th John Deutsch Roundtable on Economic Policy, 1988) 283; David Bradford, "Tax Expenditures and the Problem of Accounting for Government" (The 7th John Deutsch Roundtable on Economic Policy, 1988) 427; Paul R. McDaniel and Stanley S. Surrey, eds., *International Aspects of Tax Expenditures: a Comparative Study* (Deventer, Netherlands: Kluwer Law and Taxation, 1985).

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## Text of the General Anti-Avoidance Rule

The current version of GAAR reads as follow:

**245.(1) Definitions.** -- In this section and in subsection 152(1.11), "tax benefit". -- "tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act;

"tax consequences". -- "tax consequences" to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount;

"transaction". -- "transaction" includes an arrangement or event.

(2) **General anti-avoidance provision.** -- Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

(3) **Avoidance transaction.** -- An avoidance transaction means any transaction

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

(4) **Provision not applicable.** -- For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.



**(5) Determination of tax consequences.** -- Without restricting the generality of subsection (2),

(a) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,

(b) any such deduction, any income, loss or other amount or part thereof may be allocated to any person,

(c) the nature of any payment or other amount may be recharacterized, and

(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored, in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section result, directly or indirectly, from an avoidance transaction.

**(6) Request for adjustments.** -- Where with respect to a transaction

(a) a notice of assessment, reassessment or additional assessment involving the application of subsection (2) with respect to the transaction has been sent to a person, or

(b) a notice of determination pursuant to subsection 152(1.11) has been sent to a person with respect to the transaction

any person (other than a person referred to in paragraph (a) or (b)) shall be entitled, within 180 days after the day of mailing the notice, to request in writing that the Minister make an assessment, reassessment or additional assessment applying subsection (2) or make a determination applying subsection 152(1.11) with respect to that transaction.

**(7) Exception.** -- Notwithstanding any other provision of this Act, the tax consequences to any person, following the application of this section, shall only be determined through a notice of assessment, reassessment, additional assessment or determination pursuant to subsection 152(1.11) involving the application of this section.

**(8) Duties of Minister.** -- Upon receipt of a request by a person under subsection (6), the Minister shall, with all due dispatch, consider the request and notwithstanding subsection 152(4), assess, reassess or make an additional assessment or determination pursuant to subsection 152(1.11) with respect to that person, except that an assessment, reassessment, additional assessment or determination may be made under this subsection only to the extent that it may reasonably be regarded as relating to the transaction referred to in subsection (6).