

# “To GAAR or Not to GAAR—That is the Question:” Canadian and Australian Attempts to Combat Tax Avoidance

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*In both Canada and Australia the relevant governments found their initial legislative attempts to combat tax avoidance to be ineffective. In time in each country it was concluded that the respective general avoidance provisions were of limited application and ineffective to combat the sophisticated tax avoidance schemes promoted by tax advisers. In Canada it was determined that Income Tax Act, R.S.C 1985, s. 245(1) would be repealed and replaced with a general anti-avoidance rule ('GAAR') contained in a new s. 245 ITA. The Australian government similarly decided to replace Income Tax Assessment Act, Cth. 1936, s. 260 with a new general anti-avoidance measure, Part IVA ITAA. This article compares and contrasts the Canadian and Australian GAARs. Through the evaluation of each regime the article seeks to identify which model is most effective. It will be seen that both regimes have some features that are preferable to the other and thus both GAARs might be improved by incorporating aspects of the other anti-avoidance model.*

*Au Canada comme en Australie, les gouvernements respectifs ont jugé leurs mesures législatives initiales pour lutter contre l'évitement fiscal inefficaces. En temps et lieu les deux pays ont conclu que leurs dispositions générales respectives visant à décourager l'évitement fiscal étaient d'application limitée et inefficaces pour lutter contre les plans d'évitement fiscaux complexes que favorisent les fiscalistes-conseils. Le Canada a décidé d'abroger le paragraphe 245(1) de la Loi de l'impôt sur le revenu, L.R.C. 1985 et de lui substituer un nouvel article 245 énonçant une règle générale anti-évitement. Similairement, le gouvernement australien a décidé de remplacer son article 260 de la Income Tax Assessment Act, Cth. 1936 par une nouvelle mesure générale anti-évitement énoncée à la partie IVA de cette loi. Le présent article compare les mesures générales anti-évitement canadiennes et australiennes, souligne leurs différences et évalue chaque régime afin de déterminer quel modèle est le plus efficace. Cette analyse révèle que chaque régime présente certains aspects plus favorables et qu'on pourrait améliorer l'un et l'autre en incorporant ces aspects de l'autre modèle d'anti-évitement.*

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# “To GAAR or Not to GAAR—That is the Question:” Canadian and Australian Attempts to Combat Tax Avoidance

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## I. Introduction

TAX AVOIDANCE HAS BEEN A PROBLEM for governments since taxes were first introduced. Thirteenth century English property taxes were avoided by taxpayers moving their assets outside the sheriff's jurisdiction.<sup>1</sup> Even more conniving were the citizens of 17th century England who avoided the Window Tax<sup>2</sup> by covering their windows before the tax collector's visit.<sup>3</sup>

Combating tax avoidance in the modern world is no less difficult. In both Canada and Australia the relevant governments have found their initial legislative attempts to combat tax avoidance to be ineffective. In both cases this was largely due to the courts using an excessively literal interpretation of the respective tax legislation,<sup>4</sup> rather than a purpose

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1. Lehmann and Coleman, *Taxation Law in Australia*, 3rd ed. (Sydney: Butterworths, 1994) at 1.8.
  2. Under this tax the extent of a householder's wealth was measured by the number of windows in his or her house. This is not the only example of a tax based upon a taxpayer's consumption of luxury items. Other examples of such English taxes include: hat tax (1748–1811), glove tax (1785–1794), almanac tax (1711–1834), dice duty (1711–1862), hair powder tax (1786–1869), perfume tax (1786–1800) and wallpaper tax (1712–1836). See further Ben Schott, *Schott's Original Miscellany* (New York: Bloomsbury Publishing, 2002) at 10.
  3. Woellner et al., *2004 Australian Taxation Law*, 14th ed. (Sydney: CCH Australia, 2004) at para. 1–080 [Woellner].
  4. In Australia this was under the lead of Barwick C.J. See e.g. *Mullens v. FCT* (1976), 135 C.L.R. 290, 6 A.T.R. 504 [Mullens cited to C.L.R.]; *Patcorp Investments Ltd. v. FCT* (1976), 140 C.L.R. 247, 6 A.T.R. 420 [Patcorp cited to C.L.R.]; *Shuttskin v. FCT* (1977), 140 C.L.R. 314, 7 A.T.R. 166 [Shuttskin cited to C.L.R.]; *Cridland v. FCT* (1977), 140 C.L.R. 330, 77 A.T.C. 4538 [Cridland cited to C.L.R.]; *FCT v. Westraders Pty Ltd.*, [1979–80] 144 C.L.R. 55, (1980) 80 A.T.C. 4357 at 4358 (H.C.A.) [Westraders cited to A.T.C.]. In Canada the leading case supporting this approach, known as the “legal rights” approach, is *Shell Canada Ltd. v. The Queen*, [1999] 3 S.C.R. 622, 4 C.T.C. 313, 99 D.T.C. 5669 [Shell Canada cited to S.C.R.]. It will be seen that in *Canadian Pacific Ltd. v. The Queen*, [2002] 3 F.C. 170; [2002] 2 C.T.C. 197, 2001 FCA 398 [Canadian Pacific cited to F.C.], the courts applied the legal rights approach, espoused in *Shell Canada*, to significantly (and incorrectly in the author's view) read down the Canadian general anti-avoidance rule (“GAAR”). See also Lisa Philipps, “The Supreme Court of Canada's Tax Jurisprudence: What's Wrong with the Rule of Law” (2000) 79 Can. Bar Rev. 120 at 142–144; David G. Duff, “Weak-Currency Borrowings and the General Anti-Avoidance Rule in Canada: From *Shell Canada* to *Canadian Pacific*” (2001) I.B.F.D. 233 [Duff, “Weak-Currency”]; Brian J. Arnold, “The Long, Slow, Steady Demise of the General Anti-Avoidance Rule” (2004) 52(2) Can. Tax. J. 488 at 504–511 [Arnold, “Anti-Avoidance”].

test,<sup>5</sup> and adopting an approach that legitimized arrangements that were structured to minimize tax by taking advantage of loopholes in the relevant legislation.<sup>6</sup> In time each country concluded that the respective general avoidance provisions<sup>7</sup> were of limited application and ineffective<sup>8</sup> to combat the sophisticated tax avoidance schemes promoted by tax advisers.<sup>9</sup> In

5. In Canada the impetus for the introduction of the GAAR was the Supreme Court of Canada's rejection of the business purpose test in *Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536, C.T.C. 294, 84 D.T.C. 6305 [Stubart cited to S.C.R.]. Under the legal rights test, statutory provisions are given their "plain" or "literal" meaning, rather than a purposive interpretation, and the "legal effect" of a transaction, rather than its commercial or economic substance, prevails. See *Shell Canada*, *ibid.* at paras. 39–40, 45. Compare Arnold & Wilson, "The General Anti-Avoidance Rule-Part 1" (1988) 36 Can. Tax. J. 829 [Arnold & Wilson, "Part 1"]; Arnold, "Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance" (2001) 49(1) Can. Tax. J. 1; Ward & Pagone, "The Canadian Experience with a General Anti-Avoidance Rule ('GAAR')" World Tax Conference 2002, 22–24 May 2002, London at 1–4; Arnold, "Anti-Avoidance", *ibid.* at 488 and 492. See also David A. Ward & Maurice C. Cullity, "Abuse of Rights and the Business Purpose Test" (1981) 29 Can. Tax. J. 451 and Ward *et al.*, "The Business Purpose Test and Abuse of Rights" (1985) Br. Tax. Rev. 68. On the general use of this statutory interpretation principle in Australia, see *Europa Oil (NZ) Ltd. No. 2 v. IRC (NZ)* (1976), 76 A.T.C. 6001 at 6006–6007, 6 A.T.R. 744 (P.C.) [Europa No. 2 cited to A.T.C.]; *FCT v. South Australian Battery Makers* (1978), 140 C.L.R. 645 at 658, 660. Note in regard to the former decision that while it was a decision of the Privy Council, Barwick C.J. was again the 'author' of the majority judgment.
6. Two key doctrines that made the original anti-avoidance provision in Australia, *Income Tax Assessment Act 1936* (Cth.), s. 260 ('ITAA'), ineffective were the choice principle and the antecedent transactions test. Under the choice principle, that the transaction was entered into deliberately to obtain a tax benefit did not prevent a taxpayer taking advantage of these 'exempting' doctrines. See *Cridland*, *supra* note 4 at 339–340. Under the antecedent transactions test there must be a change to an existing arrangement before s. 260 will apply. See *Europa No. 2*, *ibid.* at 475; *Mullens*, *supra* note 4 at 294; *Cridland*, *supra* note 4 at 339–340; *Gulland, Watson and Pincus v. FCT* (1985), 85 A.T.C. 4765, 17 A.T.R. 1, (1985–86) 160 C.L.R. 55 at 73 and 111 [Gulland cited to C.L.R.]; *FCT v. Bunting* (1989), 89 A.T.C. 4358 at 4363 (F.C.A.) [Bunting]; *Rippon v. FCT* (1992), 23 A.T.R. 209, 92 A.T.C. 4186 at 4191–4192 (F.C.A.) [Rippon cited to A.T.C.]. Under this doctrine, s. 260 will not apply where there has been no alteration of a pre-existing source of income, but rather a tax effective structuring of a new source of income. The Canadian courts had also adopted a doctrine not unlike the choice principle. Thus in *Shell Canada*, *ibid.* at para. 45 McLachlin J. stated that "absent a specific provision to the contrary, it is not the court's role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that that the particular provisions of the Act are met, on the basis that it would have been inequitable to those taxpayers who have not chosen to structure their transactions that way. Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done." In turn, one of the transactions in *Canadian Pacific*, *supra* note 4, namely, the New Zealand weak currency transaction that pre-dated the introduction of the Canadian GAAR, was not challenged on appeal because the reasoning in *Shell Canada*, *ibid.* validated the arrangement: See *Canadian Pacific*, *supra* note 4 at para. 12.
7. In the case of Canada, the relevant provision was *Income Tax Act*, R.S.C. 1985, c.1 ('ITA'). The original version of s. 245(1) applied where, for example, an expense was "incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce" the taxpayer's income. In the case of Australia, the relevant provision was s. 260 of the ITAA.
8. Canada, Department of Finance, *The White Paper: Tax Reform 1987* (Ottawa, Department of Finance, 18 June 1987) at 70 [Department of Finance, *White Paper*]. Regarding Australia, see *FCT v. Peabody* (1993), 25 A.T.R. 32, 93 A.T.C. 4104 at 4110 (F.C.A.) [Peabody 2 cited to A.T.C.]; *John v. FCT* (1989), 89 A.T.C. 4101 at 4108 (F.C.A.) [John]; *Davis v. FCT* (1989), 86 A.L.R. 195, 89 A.T.C. 4377 at 4399 (F.C.A.) [Davis]; *Case W58* (1989), 89 A.T.C. 524 at 533 (A.A.T.) [Case W58].
9. Department of Finance, *White Paper*, *ibid.* at 211. Re Australia, see Grbich, "Problems of Tax Avoidance in Australia" in J.G. Head, ed., *Tax Issues of the 1980s* (Sydney: Australian Tax Research Foundation, 1983) at 416 and 424–426; *Woellner*, *supra* note 3 at para. 1–090. Unfortunately, in recent years this practice of the 1970s and 1980s has been resurrected. The government is also very concerned as to the increase in mass marketed tax schemes in recent years: Australian Tax Office, *Annual Report 2002–2003*.

Canada, it was determined that the *Income Tax Act*, R.S.C. 1985 ('ITA'), section 245(1) would be repealed and replaced with a general anti-avoidance rule ('GAAR') contained in a new section 245 ITA.<sup>10</sup> The Australian government similarly decided to replace the *Income Tax Assessment Act*, Cth. 1936 ('ITAA'), section 260 with a new general anti-avoidance measure, Part IVA ITAA,<sup>11</sup> and purportedly buried the doctrines that had rendered section 260 largely ineffective.<sup>12</sup> Both GAARs were designed to "prevent artificial tax avoidance arrangements."<sup>13</sup> In Canada, this was to be facilitated by introducing a 'business purpose' test and a 'step transaction' approach into the ITA.<sup>14</sup>

While the current Canadian GAAR applies to transactions entered into on or after 13 September 1988, nearly a decade passed before it was first considered by the courts in *McNichol v. The Queen*.<sup>15</sup> Since that case the legislation has had only limited judicial consideration and was only considered by the Court of Appeal for the first time in 2001, in *OSFC Holdings Ltd. v. The Queen*.<sup>16</sup> To date there has been no consideration of the provisions by the Supreme Court of Canada.<sup>17</sup> Equally, there has not been a wealth of judicial discussion of Part IVA of the ITAA in Australia. While Part IVA of the ITAA

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10. Introduced by s. 185 *Income Tax Act 1988*. Generally, the new s. 245 applies to transactions entered into or after 13 September 1988. Note the GAAR recently 'survived' a constitutional challenge in *Kaulius et al. v. The Queen* (2003), D.T.C. 5644, 2003 FCA 371, leave to appeal to S.C.C. granted [*Kaulius*].
  11. Part IVA generally applies to schemes entered into after 27 May 1981. See ITAA, *supra* note 6 at s. 177D. Where the tax benefit is the incurring of a capital loss the scheme must have been entered into after 3:00 p.m. 29 April 1997. Where the tax benefit is the obtaining of a foreign tax credit the scheme must have been entered into after 4:00 p.m. 13 August 1998. Where the tax benefit arises from avoiding withholding tax, this must occur after 20 August 1996.
  12. See further *Peabody 2*, *supra* note 8 at 4110; *John*, *supra* note 8 at 4108; *Davis*, *supra* note 8 at 4399; *Case W58*, *supra* note 8 at 533.
  13. See Department of Finance, *White Paper*, *supra* note 8 at 70. In Australia the Treasurer stated that Part IVA was introduced "to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of the opportunity available for the arrangement of their affairs": Austl., Commonwealth, House of Representatives, *Parliamentary Debates*, (27 May 1981) at 2683-2684 (Mr. Howard, Treasurer) [*Second Reading Speech*].
  14. See Department of Finance, *White Paper*, *ibid*. This latter point is highly relevant to the discussion below of one of the leading Canadian cases. See *Canadian Pacific*, *supra* note 4.
  15. [1997] 2 C.T.C. 2088, 97 D.T.C. 111 [*McNichol*]. There was an earlier decision of the Canadian International Trade Tribunal. See *Michelin Tires (Canada) Ltd. v. MNR* (1995), 3 G.T.C. 4040, 1995 GSTC 17 (CITT). See further *Michelin Tires (Canada) Ltd. v. MNR*, [2000] G.T.C. 4070, [2000] 3 F.C. 418 [*Michelin 2*].
  16. [2002] 2 F.C. 288, [2001] 4 C.T.C. 82, 2001 D.T.C. 5471, 2001 FCA 260 [OSFC], *aff'g* [1999] 3 C.T.C. 2649, 99 D.T.C. 1044 (T.C.C.). The Court of Appeal has only considered the provisions on few occasions since. See *The Queen v. Donahue Forest Products Inc.*, 2002 FCA 422 [*Donahue*]; *Jabin Investments Ltd. v. The Queen* (2002), 300 N.R. 142, 2002 FCA 520 [*Jabin*]; *Canadian Pacific*, *supra* note 4; *STB Holdings Ltd. v. The Queen*, [2003] 3 F.C. 626, 2002 FCA 386 [*STB*]; *Water's Edge Village Estates (Phase II) v. The Queen*, [2003] 2 F.C. 25, [2002] 4 C.T.C. 1, 2002 FCA 291 [*Water's Edge*]; *Kaulius*, *supra* note 10; *Imperial Oil Ltd. v. The Queen*, [2004] D.T.C. 6044, 2004 FCA 36 [*Imperial Oil*]; *Canada Trustco Mortgage Company v. The Queen*, [2004] D.T.C. 6119, [2004] 2 C.T.C. 276, 2004 FCA 67; leave to appeal to S.C.C. granted [2004] S.C.C.A. No. 157 (Q.L.) [*Canada Trustco*].
  17. On 24 June 2004 leave was granted to appeal the decision in *Canada Trustco*, *ibid*. This will be the first Supreme Court decision on the GAAR.

governs tax avoidance schemes entered into, or furthered, after 27 May 1981, a decade passed between this date and the first judicial<sup>18</sup> consideration of the substantive operation of Part IV A of the *ITAA*, found in *Peabody v. FCT*.<sup>19</sup> While there has been a recent flurry of cases<sup>20</sup> considering Part IVA of the *ITAA*, to a large extent a dearth of authority on the scope and meaning of these provisions continues.<sup>21</sup>

This article compares and contrasts the Canadian and Australian GAARs. Through the evaluation of each regime the article seeks to identify which model is most effective. It will be seen that both regimes have some features that are preferable to the other and thus both GAARs might be improved by incorporating aspects of the other anti-avoidance model.<sup>22</sup>

## II. Legislative Framework

### A. CANADIAN GAAR

This article analyzes each of the relevant elements of the Canadian GAAR: (i) “avoidance transaction”; (ii) “tax benefit”; (iii) primary “purpose” of obtaining the tax benefit; and (iv) “misuse” of provision(s) and/or “abuse” of the Act. Each is then evaluated in light of the comparable Australian element. Before this is undertaken a brief introduction of the two legislative regimes is necessary.

The key charging provision under the Canadian GAAR is section 245(2) *ITA*:

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.

18. Though there had been earlier decisions by the Administrative Appeals Tribunal, most notably, *Case W58*, *supra* note 8.

19. (1992), 92 A.T.C. 4585 (F.C.A.) [*Peabody 1*].

20. See, for example, *Egan v. FCT*, (2001) A.T.C. 2185 (A.A.T.) [*Egan*]; *FCT v. Consolidated Press Holdings Ltd.* (2001), A.T.C. 4343 (H.C.A.) [*Consolidated Press*]; *FCT v. Metal Manufacturers* (2001), A.T.C. 4152 (F.C.A.) [*Metal Manufacturers*]; *Eastern Nitrogen v. FCT* (2001), A.T.C. 4164 (F.C.A.) [*Eastern Nitrogen*]; *Vincent v. FCT* (2002), A.T.C. 4742 (F.C.A.) [*Vincent*]; *Mochkin v. FCT*, (2002) A.T.C. 4465 [*Mochkin 1*]; *Mochkin v. FCT*, (2003) A.T.C. 4272 (F.C.A.) [*Mochkin 2*]; *Sleight v. FCT*, [2003] 53 A.T.R. 667, [2003] F.C.A. 896 [*Sleight* cited to A.T.R.]; *Puzey v. FCT*, [2003] F.C.A.F.C. 197 [*Puzey*]; *FCT v. MacArthur*, [2003] F.C.A. 903 [*MacArthur*]; *Hart v. FCT* (2002), A.T.C. 4608 (F.C.A.) [*Hart 2*], *rev'd* [2004] H.C.A. 26 [*Hart 3*].

21. Until recently there were only three substantive considerations of Part IVA *ITAA*. See *Peabody 2*, *supra* note 8 and *Peabody 1*, *supra* note 19 and on further appeal (1994), 94 A.T.C. 4663 (H.C.A.) [*Peabody 3*]; *Osborne v. FCT* (1995), 95 A.T.C. 4323 (F.C.A.) [*Osborne*]; *Spotless Services Ltd. v. FCT* (1993), 93 A.T.C. 4397 (F.C.A.) [*Spotless 1*], *aff'd* (1995), 95 A.T.C. 4775 (F.C.A.) [*Spotless 2*], *rev'd* (1996), 96 A.T.C. 5201 (H.C.A.) [*Spotless 3*].

22. For example, it will be contended that the Canadian “step transaction” approach is less complicated than the Australian use of the notion of “scheme.” Equally, though it is suggested that the role and scope of the Canadian exemption, detailed in s. 245(4) *ITA*, is unclear and the Australian exclusionary limb, contained in s. 177C(2)–(3) *ITAA*, is more specific in its scope.

“[T]ax consequences” is defined as “the amount of income, taxable income, or taxable income earned in Canada or, 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” (section 245(1) *ITA*). An “avoidance transaction” is defined in section 245(3) *ITA* as 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.

A “transaction” is in turn defined as “an arrangement or event” (section 245(1) *ITA*). A “series of transactions or events” is deemed under section 248(10) *ITA* to “include any related transactions or events completed in contemplation of the series.” A “tax benefit” is broadly defined in section 245(1) *ITA* as “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.”

Section 245 *ITA* also includes an “exception.” Under section 245(4) *ITA*, section 245(2) *ITA* will 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.”

## B. AUSTRALIAN GAAR

For Part IVA *ITAA* to apply there must be a (i) “scheme” that provides (ii) the “relevant taxpayer” with a (iii) “tax benefit” and a (iv) person must have entered into the scheme for the sole or dominant purpose of enabling the relevant taxpayer to obtain a tax benefit (section 177D).<sup>23</sup> If all elements are satisfied, Part IVA *ITAA* allows the Commissioner to cancel the whole or part of the tax benefit stemming from the subject scheme (section 177F). Part IVA also allows for reconstruction insofar as the Commissioner may make a fair and reasonable compensatory adjustment (sections 177F and 177G *ITAA*).

Scheme is defined in exceptionally broad terms in section 177A(1) *ITAA*:

23. Part IVA *ITAA* also applies to dividend stripping schemes (s. 177E *ITAA*) and franking credit schemes (s. 177EA *ITAA*). See further these provisions for the prerequisites necessary for Part IVA to apply to these specific schemes.

(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings and;

(b) any scheme, plan, proposal, action, course of action or course of conduct.

This definition is extended by section 177A(3) *ITAA* to include unilateral schemes. It will be seen that the notion of “scheme” has been subject to important judicial extrapolation.<sup>24</sup>

The “relevant taxpayer” is the person who obtains the tax benefit stemming from the scheme (section 177D *ITAA*). Originally “tax benefit” was defined in terms of the non-inclusion of an amount that would or might reasonably be expected to be included in the taxpayer’s income<sup>25</sup> or the allowance of a deduction that would or might not have been expected to be allowable, but for the scheme (section 177C(1)). As this definition was exhaustive in its terms, any other tax benefit, such as a rebate, credit or deferral, did not fall within the definition of tax benefit, and thus was not subject to Part IVA *ITAA*.<sup>26</sup> The scope of section 177C(1) *ITAA* has been extended by subsequent amendments. The notion of a tax benefit now includes:

- a capital loss that would or might not have been reasonably expected to be incurred but for a scheme entered into after 3 p.m. 29 April 1997; or
- a foreign tax credit that would or might not have reasonably been expected to be allowable but for a scheme entered into after 4 p.m. 13 August 1998.

Section 177CA *ITAA* also includes in the notion of tax benefit an amount that the taxpayer would or might reasonably have been expected to be liable for in withholding tax after 20 August 1996.

A person must have entered into the scheme for the sole or dominant purpose of enabling the relevant taxpayer to obtain a tax benefit (sections 177A(5) and 177D *ITAA*). In determining this matter, regard must be had to the factors listed in section 177D(b) *ITAA*:

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24. See, in particular, *Peabody 3*, *supra* note 21; See also *Spotless 2*, *supra* note 21 at 4805; *Hart 2*, *supra* note 20 at 4619, 4626–7.
25. The first limb of the s. 177C(1) *ITAA* definition of tax benefit is now clarified by s. 177C(4) *ITAA*. This provides that a tax benefit is made within s. 177C(1)(a) *ITAA* if instead of income being included in the taxpayer’s assessable income, the taxpayer makes a discount capital gain.
26. *Peabody 2*, *supra* note 8 at 4117. Note it is proposed to extend the definition of tax benefit so that it will apply generally to any reduction or deferral of tax, whether through the non-inclusion of income or allowance of a deduction, loss, rebate or credit. See Treasurer of the Commonwealth of Australia, Press Release, No. 074, “The New Business Tax System: Stage 2 Response” (11 November 1999), online: Treasurer of the Commonwealth of Australia <<http://www.treasurer.gov.au/tsr/content/pressreleases/1999/074.asp>>. To date such proposals have not been enacted.



- (i) manner in which the scheme was entered into;
- (ii) form and substance of the scheme;
- (iii) time at which scheme entered into and the length of the period during which the scheme was carried out;
- (iv) result that would be achieved but for Part IVA;
- (v) any change in financial position of the taxpayer as a result of the scheme;
- (vi) any change in financial position of any person who has a connection (i.e. family or business) with the taxpayer as a result of the scheme;
- (vii) any other consequences for the relevant taxpayer or any other person referred to in sub-paragraph (vi); and
- (viii) the nature of any connection (i.e. family or business) between the taxpayer and a person referred to in sub-paragraph (vi).

The “exemption” under the Australian GAAR is found in an exclusionary limb in the above-mentioned definition of “tax benefit.” Section 177C(2) *ITAA* excludes from the notion of tax benefit the non-inclusion of income, the allowance of a deduction, the incurring of a capital loss or allowance of a foreign tax credit that is “attributable to the making of an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option” expressly provided for by the *ITAA* or *Income Tax Assessment Act 1997* (*ITAA 1997*). The section includes, however, an extra caveat that requires that the scheme was not entered into or carried out to create a circumstance or state of affairs “which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised....”

### III. Avoidance Transaction

#### A. TRANSACTION OR SERIES OF TRANSACTIONS: CANADIAN GAAR

To be an “avoidance transaction” within section 245(3) *ITA*, set out above, three elements must be satisfied:

- there must be a “transaction” or a transaction that is “part of a series of transactions;”
- that transaction or a series would, but for the GAAR, result in a “tax benefit”<sup>27</sup>; and
- it cannot reasonably be considered that the transaction (or a transaction in the series) was undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.<sup>28</sup>

While all three elements are inextricably linked, the latter two are considered separately below.

As to the first element, it will be apparent from the above introduction that there are two alternative requirements. The facts may constitute a

27. This is known as the ‘results test.’ See *OSFC*, *supra* note 16 at para. 17.

28. This is known as the ‘purpose test.’ See *ibid*.

single isolated “transaction” (section 245(3)(a) *ITA*) or may be “part of a series of transactions” (section 245(3)(b) *ITA*). Moreover, either the isolated “transaction” (section 245(3)(a) *ITA*) or the broader “series” (section 245(3)(b) *ITA*) may result in the tax benefit. The latter subparagraph provides an important extension to the notion of “avoidance transaction.” While sections 245(3) and 248(10) *ITA* have been identified by the courts as lacking clarity<sup>29</sup> and, in particular, the reference to “the transaction” in section 245(3)(b) *ITA* has been said to be ambiguous,<sup>30</sup> ultimately the Canadian courts have resolved that under section 245(3)(b) *ITA*, it suffices if any part of the series of transactions has as its primary purpose the obtaining of the tax benefit.<sup>31</sup> Thus if the factual scenario involves, for example, four transactions, each transaction in the series must be assessed to determine its underlying purpose.<sup>32</sup> As long as the transactions are connected so as to be part of a series, as discussed below, it suffices if one transaction, one step, has the primary purpose of obtaining the tax benefit.<sup>33</sup> Once one transaction is found to have that purpose, all the other transactions that are part of the series are tainted with the illegitimate purpose.<sup>34</sup> Even if all other transactions in the series have a *bona fide* business or family purpose as their primary concern or the series as a whole has as its primary purpose a *bona fide* concern, subsection 245(3) *ITA* will nevertheless be satisfied and each transaction will be an avoidance transaction. This is designed to prevent taxpayers from inserting into a series of transactions with an overall business purpose a transaction that has no purpose other than tax.<sup>35</sup> This is known as the “step transaction” approach, noted above.

Under a literal interpretation of subsection 245(3)(b) *ITA*, the reference to “the transaction”, which is to be examined to identify the primary purpose, could refer to the particular step or transaction in which the taxpayer actually participated, rather than examining each transaction that forms part of the series. Such an interpretation would, however, render subsection 245(3)(b) *ITA* meaningless<sup>36</sup> because it would mean that if the particular transaction undertaken by the taxpayer was primarily for *bona fide* business or family reasons then, despite its connection to another transaction in the series which had been entered into primarily for tax reasons, the

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29. *Ibid.* at para. 28.

30. *Ibid.* at paras. 124–126. This ambiguity is discussed below.

31. *Ibid.* at para. 45.

32. *Ibid.* at paras. 124 and 126, quoting in support Department of Finance in its *Technical Notes to Bill C-139, Special Report No. 851*, (CCH Canadian Ltd., 1988) at 315 [*Technical Notes*]; Brian J. Arnold, Chapter 7, *Tax Avoidance and The Rule of Law* (Amsterdam: I.B.F.D. Publications, 1997) at 232–233 [*Arnold, Tax Avoidance*].

33. *Ibid.*

34. *Ibid.* at paras. 124, 126.

35. Arnold, “Anti-Avoidance”, *supra* note 4 at 493.

36. *OSFC, supra* note 16 at para. 125.

taxpayer's transaction would not be an avoidance transaction.<sup>37</sup> This would mean that subsection 245(3)(b) *ITA* would have no function beyond subsection 245(3)(a) *ITA*. Under this view, once it was ruled under subsection 245(3)(a) *ITA* that the transaction was not an avoidance transaction because of its legitimate purpose, the conclusion would be no different under subsection 245(3)(b) *ITA*.<sup>38</sup> Under this view the taxpayer's transaction would be assessed as a single transaction under both subsection 245(3)(a) and (b) *ITA* "notwithstanding that paragraph (b) defines as an avoidance transaction 'any transaction' that is part of the series of transactions which produced the tax benefit and were arranged or undertaken primarily for that purpose."<sup>39</sup>

For this reason the contrary approach taken in *Canadian Pacific Ltd. v. The Queen*<sup>40</sup> is clearly erroneous. This case involved a weak-currency borrowing arrangement.<sup>41</sup> Briefly, the taxpayer borrowed funds in Australian dollars (at a comparative high interest rate), then converted them into Canadian dollars (with a lower interest rate), the funds to be used in its Canadian operations. Repayments were made pursuant to forward contracts that locked in the foreign exchange gains from an expected depreciation of the Australian dollar. Under Canadian tax laws, the taxpayer could obtain significant tax advantages through such weak-currency borrowings.<sup>42</sup>

This case involved what authors have described as a "blatant tax avoidance scheme"<sup>43</sup> that had been "designed to obtain inflated interest deductions during the term of the loan and tax-preferred capital gains on repayment of the principal amount of the loan...."<sup>44</sup> Nevertheless, the Canadian courts held the GAAR did not apply to the arrangement.<sup>45</sup> One of the key reasons was an erroneous understanding of the impact of subsection 245(3)(b) *ITA*. Bonner T.C.J. had held that, but for the tax benefits underlying this arrangement, the taxpayer would have directly borrowed the subject funds in Canadian dollars.<sup>46</sup> While it was also accepted that the borrowing and foreign exchange transactions constituted a series, Bonner T.C.J. held that because the series as a whole had the *bona fide* purpose of borrowing capital to be used for business purposes, the GAAR could not

37. *Ibid.*

38. *Ibid.*

39. *Ibid.*

40. See e.g. *Canadian Pacific*, *supra* note 4 at 184–185. Note, s. 20.3 now specifically overrules this decision. For a fuller discussion of the case see Brian J. Arnold, "Canadian Federal Court of Appeal Refuses to Apply GAAR to Aussie/Yen Loan" (2002) 25 Tax Notes Int'l 204 [Arnold, "Aussie/Yen Loan"].

41. See also Duff, "Weak-Currency," *supra* note 4 at 234.

42. *Ibid.*

43. Brian J. Arnold, "Supreme Court of Canada Approves Blatant Tax-Avoidance Scheme" (1999) 19 Tax. Notes Int'l. 1813 [Arnold, "Tax-Avoidance Scheme"].

44. Duff, "Weak-Currency," *supra* note 4 at 233.

45. *Canadian Pacific*, *supra* note 4.

46. *Ibid.* at para. 12.

apply, even though a transaction in the series was undertaken for tax reasons.<sup>47</sup> Bonner T.C.J. held that “[n]o transaction forming part of the series can be viewed as having been arranged for a purpose which differs from the overall purpose of the series.”<sup>48</sup>

On appeal, the Federal Court asserted that the extended definition of a transaction “cannot be interpreted to justify taking apart a transaction in order to isolate its business and tax purposes. The necessity to determine primary purpose implies that there is more than one purpose and that the transaction is to be considered as a whole.”<sup>49</sup> The Federal Court reiterated that the “words of the Act require consideration of a transaction in its entirety and it is not open to the Crown artificially to split off various aspects of it in order to create an avoidance transaction.” In this case the overall purpose of borrowing was held to prevent the GAAR applying to the tax benefit arrangement despite the extended definition of transaction.<sup>50</sup>

It is not entirely clear that the Federal Court in making these comments was adopting the same approach as Bonner T.C.J. on this issue. It is arguable that Federal Court is merely saying “that one transaction within a series of transactions cannot be further divided into separate components for the purpose of finding one of those components an avoidance transaction.”<sup>51</sup> However, from other parts of the judgment it seems that the Federal Court’s reference to a “component” is to a “separate transaction” that is part of the broader series, rather than a part of a transaction.<sup>52</sup> Moreover, in light of the Federal Court’s ultimate conclusion, that is, upholding Bonner T.C.J.’s finding on the point, it appears the Federal Court may be agreeing with his view that the “series” cannot be so separated into transactions when identifying the relevant primary purpose.

If this is a correct interpretation of the Courts’ findings in this case, as stated above, this view is erroneous. As Duff notes, this approach “disregards both the text of Sec. 245(3)(b), which addresses the purpose of each transaction comprising a series of transactions, and the legislature’s express intent to introduce a ‘step transaction’ [approach]....”<sup>53</sup> The extent of the lack of understanding of the legislation is highlighted by the Federal Court’s comment that if the contrary view were adopted this would have the unintended result that it would suffice if a “separate transaction” was “undertak-

47. *Ibid.* at para. 27. Thus while there was no business purpose for arranging to borrow Australian currency when Canadian currency was used in the business, this did not mean that the GAAR applied because the overall series was based on a business purpose. Compare Ward & Pagone, *supra* note 5 at 55; Arnold, “Anti-Avoidance,” *supra* note 4 at 494-495.

48. *Ibid.* at para. 15.

49. *Ibid.* at para. 24; *Canadian Pacific 2*, *ibid.* at 184.

50. *Ibid.* at paras. 23 and 26; *Canadian Pacific 2*, *ibid.* at 184-185.

51. *Loyens v. R.*, [2003] 3 C.T.C. 2381, 57 D.T.C. 355, 2003 TCC 214 at para. 84 [*Loyens* cited to C.T.C.].

52. See *Canadian Pacific 1*, *supra* note 4 at para. 25; *Canadian Pacific 2*, *supra* note 4 at 184.

53. Duff, “Weak-Currency,” *supra* note 4 at 239.

en for purely tax purposes....”<sup>54</sup> As noted above, this was not unintended. This is the whole basis of subsection 245(3)(b) *ITA*. It suffices under subsection 245(3)(b) *ITA* that one transaction in the series has been undertaken for tax reasons.<sup>55</sup>

Once this view of subsection 245(3) *ITA* is accepted, this analysis still requires a further understanding of what is a “series of transactions” and the degree of connection that is necessary for one transaction to be part of a series. In this regard there were three possible approaches to this matter. First, subsection 245(3) *ITA* could be seen as a legislative enactment of the doctrine of fiscal nullity and, in turn, the definition of “a series of transactions or events” in subsection 248(10) *ITA* would be read down to accord with that doctrine. The doctrine of fiscal nullity, as developed by the English judiciary, renders an arrangement ineffective for tax purposes where there is a preordained composite transaction or series of transactions and inserted into this transaction(s) is a step(s) with no commercial or business purpose other than tax avoidance.<sup>56</sup> Under this common law doctrine, for two or more transactions to be seen as part of a series they must be pre-ordained to produce a final result.<sup>57</sup> Pre-ordained in this context means that when the first transaction in the series was implemented, it had been determined by a person(s) capable of implementing all subsequent transactions that each would occur.<sup>58</sup> “[T]here must be no practical likelihood that the subsequent transaction or transactions will not take place.”<sup>59</sup>

Second, the relevance of the doctrine of fiscal nullity in interpreting “series” could be recognized, but the courts could acknowledge that subsection 248(10) *ITA* extends the notion beyond the common law doctrine of fiscal nullity. Under this view, subsection 248(10) *ITA* would include in the notion of a “series” “any related transactions or events completed in contemplation of the series.” There would be no need for each transaction to be pre-ordained as long as they were related within subsection 248(10) *ITA*.<sup>60</sup>

Third, the Canadian judiciary could use the “mutual interdependence test” and the “end results test” used by some United States courts. Under the mutual interdependence test, “two or more transactions will constitute a series if the transactions are so interdependent that the legal relations creat-

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54. *Canadian Pacific 1*, *supra* note 4 at para. 25; *Canadian Pacific 2*, *supra* note 4 at 184.

55. *OSFC*, *supra* note 16 at paras. 124 and 126. In regard to the application of this principle to the *Canadian Pacific* case, see Ward & Pagone, *supra* note 5 at 16 and Arnold, “Anti-Avoidance,” *supra* note 4 at 495.

56. *Furniss v. Dawson*, [1984] A.C. 474 at 512, 1 All E.R. 530, 2 W.L.R. 226 [*Furniss* cited to A.C.]. See also *Craven v. White*, [1989] A.C. 398 at 459, [1988] 3 All E.R. 495, 3 W.L.R. 423 [*Craven* cited to A.C.].

57. *OSFC*, *supra* note 16 at para. 24.

58. *Ibid.*

59. *Ibid.*

60. *Ibid* at para. 36.

ed by one transaction would be meaningless without a completion of the series.”<sup>61</sup> Under the “end results test,” otherwise separate transactions are “amalgamated as a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.”<sup>62</sup>

The Canadian courts have been divided on which approach to adopt. The leading discussion of this issue is found in *OSFC*<sup>63</sup>. Briefly, the facts involved four key transactions. First, the liquidator of a company, Standard Company, caused the company to incorporate a subsidiary. Second, Standard Company formed a partnership (“STIL II”) with the subsidiary. Standard Company had a 99% interest in the partnership, while the subsidiary held a 1% interest. Third, Standard Company transferred its mortgage portfolio to the partnership. In short this was designed to transfer Standard Company’s loss to the partnership so that an arm’s length purchaser could acquire an interest in the partnership and thereby accrue the tax loss for the latter’s use. Fourth, the taxpayer, *OSFC Holdings Ltd.*, acquired an interest in the STIL II partnership. One of the taxpayer’s contentions was that the fourth transaction “was an independent transaction and not part of a series with the Standard transactions. Therefore, the appellant’s acquisition of the STIL II partnership interest should not be tainted by the Standard transactions.”<sup>64</sup>

Rothstein J.A., with whom Stone J.A. concurred, adopted the second of the above detailed approaches. Rothstein J.A. concluded that, subject to subsection 248(10) *ITA*, subsection 245(3)(b) *ITA* was intended to embody the doctrine of fiscal nullity. This was apparent from the government’s references to the doctrine and the leading English case, *Furniss v. Dawson*, in the course of enacting the Canadian GAAR.<sup>65</sup> In turn, Rothstein J.A. rejected the applicability of the “mutual interdependence test” and the “end results test.”<sup>66</sup>

Rothstein J.A. then turned to consider the impact of subsection 248(10) *ITA*. It was open to interpretation that subsection 248(10) *ITA* was “simply ... a statutory codification of the House of Lords definition of ‘series of transactions’”<sup>67</sup> under the doctrine of fiscal nullity and thus required pre-

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61. *Ibid.* at para. 21. See also *ibid.* at para. 130; Brian J. Arnold & James R. Wilson, “The General Anti-Avoidance Rule-Part 2” (1988) 36 Can. Tax. J. 1123 at 1162 [Arnold & Wilson, “Part 2”].

62. *Ibid.*, citing John Tiley, “Series of Transactions” in 1988 Conference Report. *Report of Proceedings of the Fortieth Tax Conference Held November 28–30, 1988* (Toronto: Canadian Tax Foundation, 1989) at 8:3–8:4. See also *OSFC*, *supra* note 16 at para. 130. See also Arnold & Wilson, “Part 2”, *ibid.*

63. *Supra* note 16.

64. *Ibid.* at para. 16. See also *ibid.* at para. 129.

65. See especially *ibid.* at paras. 22–24, citing Michael Hiltz, “Section 245 of the *Income Tax Act*” in 1988 Conference Report. *Report of Proceedings of the Fortieth Tax Conference Held November 28–30, 1988* (Toronto: Canadian Tax Foundation, 1989) at 7:7; David A. Dodge, “A New and More Coherent Approach to Tax Avoidance” (1988) 36 Can. Tax. J. 1 at 15.

66. *Ibid.* at para. 24.

67. *Ibid.* at para. 28.

ordained transactions. Rothstein J.A. concluded, however, that subsection 248(10) *ITA* provided a broader definition of a “series” and thus included in the notion transactions that would not fall within the House of Lord’s test.<sup>68</sup> “Under this approach, an independent transaction would be deemed to be included in the series for the purposes of subsection 248(10) if it is related to the transactions in the common law series and if it is completed in contemplation of the common law series.”<sup>69</sup> “Whether the related transaction is completed in contemplation of the common law series requires an assessment of whether the parties to the transaction knew of the common law series, such that it could be said that they took it into account when deciding to complete the transaction. If so, the transaction can be said to be completed in contemplation of the common law series.”<sup>70</sup> There was no need for it to be pre-ordained as under the common law.<sup>71</sup> As subsection 248(10) is a “deeming” provision, not merely a definition section, Rothstein J.A. concluded that its deeming function meant that it was extending the definition in this manner beyond the common law definition of series.<sup>72</sup> Thus Rothstein J.A. concluded that subsection 248(10) requires three considerations: “[F]irst, a series of transactions within the common law meaning; second, a transaction related to that series; and third, the completion of the related transaction in contemplation of that series.”<sup>73</sup>

Rothstein J.A. found that while the first three transactions undertaken by Standard Company were pre-ordained within the common law test,<sup>74</sup> the fourth transaction undertaken by the taxpayer would not satisfy the test and thus would not be part of the series under *Furniss v. Dawson*.<sup>75</sup> However, the fourth transaction, the taxpayer’s acquisition of the STIL II partnership interest, was connected to the first three Standard Company transactions.<sup>76</sup> “Standard, in liquidation, and the [taxpayer], the parties to the acquisition transaction, knew of the Standard series and took it into account when deciding to complete the acquisition transaction. Therefore, the [taxpayer’s] acquisition of its STIL II partnership interest was a transaction that was related to the Standard series and was completed in contemplation of that series.”<sup>77</sup> As the Tax Court Judge had found that the first three Standard Company trans-

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68. *Ibid.* at para. 29.

69. *Ibid.*

70. *Ibid.* at para. 36.

71. *Ibid.*

72. *Ibid.* at para. 33. Rothstein J.A. also pointed to the fact that when s. 245 *ITA* was enacted a “grandfather” provision was included in regard to s. 248(10) *ITA*: *Ibid.* at para. 32. See also Tiley, *supra* note 62 at 8:5.

73. *Ibid.* at para. 35.

74. *Ibid.* at para. 25.

75. *Ibid.* at para. 26.

76. *Ibid.* at para. 38.

77. *Ibid.*

actions were undertaken primarily to obtain a tax benefit,<sup>78</sup> that Court did not consider the primary purpose underlying the fourth transaction as it was in any case tainted by the avoidance transactions.<sup>79</sup> On appeal, however, Rothstein J.A. also considered the purpose underlying the fourth transaction and found that it too was primarily to obtain a tax benefit.<sup>80</sup>

Letourneau J.A. concurred with Rothstein J.A.'s result, but did not agree with Rothstein J.A.'s approach to section 245 *ITA*. With respect to the current issue, Letourneau J.A. seemed to apply the doctrine of fiscal nullity. Thus he concluded, contrary to Rothstein J.A., that the fourth transaction, the sale of the partnership interest to the taxpayer, was part of the "pre-ordained steps carried out by STC's liquidator."<sup>81</sup> Letourneau J.A., however, also went on to apply both the "mutual interdependence" and the "end result" tests to the facts, concluding both would be satisfied.<sup>82</sup> Strangely, there is no reference to subsection 248(10) *ITA*, nor any explanation as to why it was not considered. For this reason the approach of Rothstein J.A. should be preferred.

#### B. SCHEME VS. SUBSCHEME: AUSTRALIAN GAAR

The closest equivalent element to the Canadian notion of "transaction" is the requirement under Part IVA *ITAA* that there be a "scheme" under subsections 177A(1) and (3) *ITAA*. As noted above, the broad definition of scheme in subsection 177A(1) *ITAA* has been subject to important judicial extrapolation, particularly in *Peabody 3*. As a consequence of this interpretation, despite the breadth of the definition of "scheme" under subsection 177A(1) *ITAA*, the first element of Part IVA *ITAA* is far from a non-issue. First, to be a "scheme" the circumstances must be capable of "standing on their own without being 'robbed of all practical meaning.'" <sup>83</sup> It will be apparent that this formulation of a "scheme" is very similar to the "mutual interdependence test" discussed above.

Second, it is insufficient if only a part of that scheme, a "subscheme," satisfies the further elements of Part IVA *ITAA*. Thus the approach in Australia regarding a series of transactions has been completely the opposite of that in Canada where under subsection 245(3)(b) each step in the series of

78. *Ibid.* Letourneau J.A. agreed noting "there was overwhelming evidence that the incorporation of company 1004568, the formation of the STIL II partnership as well as the transfer to them of the portfolio assets were not necessary for STC to effectively sell these assets to an arm's length third party such as the appellant": *ibid.* at para. 127.

79. Compare *ibid.* at paras. 47-48.

80. *Ibid.* at paras. 49-54 and 58.

81. *Ibid.* at para. 130.

82. *Ibid.*

83. *Ibid.* at 4670. While this test has been applied by subsequent courts, as discussed below, recently, in *Hart 2*, *supra* note 20 while three members of the High Court (Gleeson C.J., McHugh and Callinan JJ.) applied this test, two Justices (Gummow and Hayne JJ.) rejected the need to satisfy this test.



transactions is considered. Thus the High Court of Australia stated in *FCT v. Peabody*:

Part IVA does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself.<sup>84</sup>

Importantly, Hill J. added in *FCT v. Peabody* that:

[W]here, as a matter of fact, a scheme consists of a course of action comprising several steps the Commissioner may [not] isolate out of that course of action one step and classify that as a scheme. ... [I]n a case where a series of steps constitutes a scheme, that whole series of steps is to be considered, the individual steps being seen as parts of the scheme rather than each step being capable of being seen as a scheme in itself.<sup>85</sup>

In *Spotless Services* the requirement that the scheme, rather than the subscheme, satisfy the further requirements of Part IVA *ITAA* was a key reason why the Court at first instance and the full court of the Federal Court, on appeal, found that Part IVA *ITAA* did not apply to the subject facts.<sup>86</sup> In this case the taxpayer companies invested funds with a bank in the Cook Islands so as to take advantage of subsection 23(q) *ITAA* that at that time exempted foreign source income that was taxed in the source country. The funds were subject to withholding tax in the Cook Islands at a rate substantially lower than Australian income tax rates. Part of the arrangement involved the taxpayer companies sending an officer to the Cook Islands to effect the loan arrangement and, on maturity, to surrender the certificate of deposit in return for the principal and interest (\$2.96 million). The Commissioner assessed the taxpayer companies on the interest on the basis that either the income was sourced in Australia or Part IVA *ITAA* applied to the arrangement.

As noted above, both the Court at first instance and the majority of the full court of the Federal Court on appeal rejected the Commissioner's suggestion that Part IVA *ITAA* applied to the arrangement. Both courts held that the Commissioner's original formulation of the scheme, which was confined to the taxpayers' officer travelling to the Cook Islands with the relevant authority to effect the transactions, was too narrow and not capable of standing on its own within the High Court's definition of a "scheme."<sup>87</sup> This formulation of the scheme ignored other integral aspects of the arrange-

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84. *Ibid.*

85. *Peabody 2*, *supra* note 8 at 4111.

86. While on further appeal to the High Court of Australia the Courts' ultimate conclusion was reversed; this was because the High Court disagreed with the lower Court's findings as to the taxpayers' dominant purpose. The High Court ultimately concluded that the dominant purpose was to obtain a tax benefit within Part IVA *ITAA*: *Spotless 3*, *supra* note 21 at 5210 and 5212. The case nevertheless provides evidence of the importance of the scheme vs. subscheme approach under Part IVA *ITAA*.

87. *Spotless 1*, *supra* note 21 at 4416; *Spotless 2*, *supra* note 21 at 4805.

ment that occurred both prior to and after the officer travelled to the Cook Islands to effect the loan arrangement.<sup>88</sup> It was asserted that the scheme had to incorporate all of the relevant facts of the case.<sup>89</sup> Once all the relevant facts were incorporated into the scheme, these courts concluded that the dominant purpose underlying the scheme was not tax avoidance, but commercial concerns.<sup>90</sup>

Note, as the doctrine of fiscal nullity was devised in response to the absence of a general anti-avoidance provision in the English taxation legislation, the existence of, among other things, Part IVA *ITAA* has been held by the Australian courts to render the doctrine inapplicable to the Australian context.<sup>91</sup>

### C. EVALUATION

The Canadian use of the terms “transaction” and “series of transactions” has much to commend when compared to the Australian use of the term “scheme” and the judicial approach to this notion. First, the inclusion of the Canadian deeming provision, subsection 248(10) *ITA*, that defines a “series” in terms broader than the common law largely eliminates the need to consider the difficult question under the Australian Part IVA *ITAA* whether the subject factual arrangement is a “scheme” or a mere “subscheme.”

Second, paragraph 245(3)(b)’s explicit recognition that it suffices under the Canadian GAAR if one transaction in the series—the equivalent of a “subscheme” under the Australian regime<sup>92</sup>—has the requisite primary purpose of obtaining the tax benefit, rather than requiring as under the Australian regime that the scheme as a whole be so characterized,<sup>93</sup> means that the issue of identifying the actual scheme is largely nugatory. Once the connection between the transactions is established, what facts constitute the actual “scheme” is not important under the Canadian GAAR as the existence of the prohibited purpose prevailing over one part of the scheme will suffice to taint the whole scheme.

The significance of the differences in this regard in the two GAARs can perhaps best be gauged by returning to the leading Canadian and Australian cases on this point. In *OSFC Holdings*<sup>94</sup> the difference in approach

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88. *Ibid.*

89. *Spotless 1, ibid.* at 4797 and *Spotless 2, ibid.* at 4805.

90. Note again that on further appeal the High Court of Australia disagreed with this factual conclusion. The High Court ultimately concluded that the dominant purpose was to obtain a tax benefit within Part IVA *ITAA*: *Spotless 3, supra* note 21 at 5210 and 5212.

91. *John, supra* note 8 at 4110.

92. In this regard recall that to be part of the series the transaction has to be “related” and “completed in contemplation of the series” within s. 248(10) *ITA*.

93. Equally, there is no need for the series of transactions as a whole to be justified by a non-tax purpose, as long as each step/transaction in isolation is based on a *bona fide* non-tax purpose: Arnold & Wilson, “Part 2”, *supra* note 61 at 1161.

94. *OSFC, supra* note 16.

would not have led to a different conclusion. This is, however, premised on the specific facts in that case and, in particular, that each of the four transactions in the series had a primary purpose of obtaining a tax benefit.<sup>95</sup> Had a contrary factual conclusion been reached, the differences in the two approaches could have been crucial.

Given the interrelationship between each of the transactions as found by the Court,<sup>96</sup> under the Australian approach each transaction would only have constituted a subscheme. Without the other transactions, each transaction would have been a meaningless step that could not stand on its own. Thus the combination of all four transactions, all the facts, would have been necessary to constitute the “scheme”. In turn under Part IVA *ITAA* it would have been necessary to consider the primary purpose of the whole scheme, not just one transaction in the series. In slightly different circumstances the scheme viewed as a whole might not be so readily viewed as an avoidance transaction. As Rothstein J.A. noted, there were both business and tax benefit purposes underlying the acquisition of the partnership interest. The taxpayer was in the “business of acquiring, arranging and improving distressed properties” and had a “*bona fide* business purpose in acquiring the STIL II Partnership interest from Standard.”<sup>97</sup> Equally from Standard Company’s perspective, it could be contended that the primary purpose of the liquidator was a business one, that being the most effective sale of Standard Company’s assets. To this end it was contended, but rejected by the Courts, that Standard Company’s primary purpose was enhancing the “value of the STIL II portfolio and to provide greater flexibility in dealing with the assets of Standard.”<sup>98</sup> If the scheme as a whole was characterized as being for business purposes, under the Australian approach it would not suffice that one step, whether that be Standard Company’s transfer of the portfolio to the partnership or the taxpayer’s acquisition of the partnership interest, was for the primary purpose of obtaining a tax benefit. By contrast, under the Canadian GAAR, that one step was based on tax concerns would have been sufficient to taint the whole series of transactions.

Similar conclusions as to the significance of the differences in the two GAARs flow from a consideration of *Spotless Services Ltd. v. FCT*. The facts have been briefly set out above, but are reiterated in a little more detail. The

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95. *OSFC*, *supra* note 16 at paras. 47–48 and 127.

96. The Standard Company transaction had the effect of transferring the portfolio to the partnership so that the cost base of the assets of the partnership would include Standard Company’s loss. It was that cost base and the consequent loss that would accrue to the taxpayer when, by the fourth transaction, the taxpayer acquired its interest in the partnership. The scheme as devised by the liquidator was premised on the arm’s length purchase of the partnership interest by a third party, which would transform the “pregnant” losses into real losses in the hands of the third party. See *OSFC*, *ibid.* at paras. 38 and 130.

97. *Ibid.* at para. 49. Ultimately, on the facts, tax benefits were said to be the primary objectives: *ibid.* at paras. 49–54 and 57.

98. *Ibid.* at para. 47.

successful public float of Spotless Services Ltd. left the taxpayer companies, Spotless Services Ltd. and Spotless Finance Pty Ltd., with a surplus of funds (\$40 million) to invest in a suitable short term investment vehicle. An investment adviser provided them with an information memorandum that detailed the rather complex steps that had to be undertaken if the taxpayer wished to invest with a bank in the Cook Islands, European Pacific Banking Co Ltd ('EPBCL'). A legal opinion supplied with the information memorandum stated that the interest would be exempt from Australian taxation under subsection 23(q) *ITAA* as the steps outlined in the information memorandum would ensure that the source of the interest was the Cook Islands and hence outside Australia.

In accordance with this procedure the taxpayers received a telexed offer from EPBCL for the investment of their funds. The taxpayer companies negotiated a higher rate of interest than that offered by EPBCL. The interest was, however, still approximately four percent below the Australian bank bill buying rate. The taxpayers proceeded to invest the \$40 million in the manner detailed above. The taxpayers sent one of their officers, Mr Levy, to the Cook Islands as attorney with authority to draw a cheque for \$40 million from the EPBC account, deposit the cheque with EPBCL and receive the certificate of deposit. On maturity, and the surrender of the certificate of deposit, the principal (\$40 million) and interest (\$2.96 million), less withholding tax, were repaid in Australia. The taxpayer companies claimed in their taxation returns that the interest was exempt from Australian tax under subsection 23(q) *ITAA*.

As noted above, the Commissioner's original formulation of the scheme was confined to the taxpayers' officer travelling to the Cook Islands with the relevant authority to effect the transactions. As also noted above, this was held by the Courts to be a subscheme as it was too narrowly formulated factually and was not capable of standing on its own within the High Court's test.<sup>99</sup> Rather, the scheme had to include all the relevant facts that occurred both prior to and after the officer travelled to the Cook Islands to effect the loan arrangement.

If for the purposes of this example we accept the factual conclusions

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99. *Spotless 1*, *supra* note 21 at 4416; *Spotless 2*, *supra* note 21 at 4805.

of the majority Justices<sup>100</sup> in the full court of the Federal Court, the dominant purpose underlying the scheme as a whole was obtaining a commercial benefit,<sup>101</sup> namely “obtain[ing] the maximum return on the money invested after the payment of all applicable costs, including tax.”<sup>102</sup> That a step in that scheme had as its dominant purpose obtaining a tax benefit did not suffice. By contrast, had the Canadian GAAR been applied, that the scheme as a whole was based on business purposes would not have prevented it being characterized as an avoidance transaction. That even one transaction was inserted into the series of transactions with a primary purpose other than a *bona fide* purpose meant that the whole scheme was tainted and constituted an avoidance transaction under subsection 245(3)(b) *ITA*.

Thus in a given case the reach of the Canadian GAAR in this regard will be significantly broader than Part IVA *ITAA* and avoids the complexities that have arisen under the Australian scheme vs. subscheme approach. Perhaps it is for this reason that the Canadian courts have not had to consider whether the CCRA is bound by its original formulation of the avoidance transaction or whether the CCRA or a court hearing an appeal might suggest an alternative factual formulation. As it suffices if only one transaction in the series is based on tax considerations, there is no need to suggest variations of the factual formulation of the series under the Canadian GAAR. By contrast, in Australia, because of the importance of identifying a scheme that meets the Australian High Court’s definition of a scheme, yet also satisfies the other prerequisites of Part IVA *ITAA*, the ability to apply Part IVA to alternative factual formulations of the scheme has been critical in some cases. While initially divided on the matter, ultimately the Australian courts have concluded that the Commissioner of Taxation or any relevant tribunal or Court may so suggest alternative formulations of the scheme to which Part IVA *ITAA* may be applied.<sup>103</sup>

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100. Cooper J., with whom Northrop J. agreed. Beaumont J. in his dissent concluded that the overall scheme was “fiscally or tax driven” in the sense that it was based on exempting the income from Australian tax: “Furthermore, in my view, it is not a fair description of these transactions to suggest that the taxation aspects were merely incidental or consequential.... The fiscal aspects were highlighted in the contemporary documentation. They were clearly at the forefront of the parties’ consideration. Without the taxation benefits, the proposal made no sense.” *Spotless 1*, *ibid.* at 4798. Beaumont J. could not identify any commercial justification for the scheme: *ibid.* Note again, on appeal, the High Court of Australia adopted Cooper J.’s formulation of the scheme, but reversed the full Federal Court’s ultimate conclusion, finding that the taxpayers’ dominant purpose was obtaining a tax benefit within Part IVA *ITAA*: *Spotless 3*, *ibid.* at 5210 and 5212.

101. *Spotless 2*, *ibid.* at 4810 and 4812.

102. *Ibid.* at 4812.

103. See generally *Peabody 3*, *supra* note 21 at 4670; *Spotless 2*, *ibid.* at 4794, 4803; *Egan*, *supra* note 20; *Hart 2*, *supra* note 20 at 4619; *Mochkin 2*, *supra* note 20 at 4278. If, however, adopting a new formulation of the scheme at a particular stage of the proceedings would unfairly prejudice the taxpayer, that alternative formulation of the scheme cannot be relied upon: *Peabody 3*, *ibid.*; *Mochkin 2*, *ibid.* at 4278 and 4281.

## IV. Tax Benefit

### A. REDUCTION, AVOIDANCE OR DEFERRAL OF TAX OR OTHER AMOUNT: CANADIAN GAAR

As noted above, a “tax benefit” is defined in exceptionally broad terms in subsection 245(1) *ITA* as “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.” The notion of “tax benefit” seems to be comprehensively defined to reflect any mode through which a benefit may be obtained through the Canadian tax regime, whether that be from the non-assessability of income, claiming deductions, rebates or credits that would not otherwise be available, the avoidance of interest or penalties or the deferral of liabilities.

While the legal definition of a tax benefit may be uncontroversial,<sup>104</sup> there is still the need to factually identify the existence of a tax benefit in a given case. Moreover, the existence of a tax benefit does not *per se* attract the Canadian GAAR. There must also be the requisite nexus between the tax benefit and the transaction/series of transactions. As would be apparent from the above discussion of the legislation, the test prescribed under the Canadian GAAR is a “but for” test: subsections 245(2) and (3) *ITA*. “But for” the GAAR, would a tax benefit directly or indirectly accrue to the taxpayer?: subsections 245(2) and (3) *ITA*. This is known as a “results test.”<sup>105</sup> “The results test requires a determination of whether a transaction or series of transactions would, but for the GAAR, result in a tax benefit.”<sup>106</sup>

Generally,<sup>107</sup> the Canadian courts approach this issue through a process known as “benchmarking.”<sup>108</sup> Under this approach the court identifies a “benchmark” transaction, “a norm or standard,” that the taxpayer might otherwise reasonably have undertaken but for the tax benefit and against this the existence of a tax benefit is determined.<sup>109</sup> The difference in the tax payable had the benchmark transaction occurred rather than the avoidance transaction is the tax benefit that has accrued to the taxpayer.<sup>110</sup> The benchmark transaction “is not a transaction which is theoretically possible but, practically speaking, unlikely in the circumstances.”<sup>111</sup> Rather a

104. *McNichol*, *supra* note 15 at 2108.

105. *OSFC*, *supra* note 16 at 301.

106. *Ibid.*

107. As noted below, in the trial decision of *Canada Trustco Mortgages Company v. The Queen*, the Court said that benchmarking is not necessary in every case: *Canada Trustco Mortgages Company v. The Queen*, [2003] 4 C.T.C. 2009 at 2030, 2003 D.T.C. 587, 2003 T.C.C. 215 [*Canada Trustco I* cited to C.T.C.].

108. David G. Duff, *Canadian Income Tax Law* (Toronto: Emond Montgomery Publications Limited, 2003) at 172 [Duff, *Canadian Income Tax Law*]; Duff, “Weak-Currency,” *supra* note 4 at 238.

109. *McNichol*, *supra* note 15 at 2108.

110. *Ibid.* See also Arnold & Wilson, “Part 2,” *supra* note 62 at 1154–1155; Duff, “Weak-Currency,” *supra* note 4 at 238.

111. *Canadian Pacific Ltd. v. The Queen*, [2000] D.T.C. 2428 at 2431 [*Canadian Pacific I*].

firmer degree of certainty is required. Thus, in *Canadian Pacific*, Bonner T.C.J. refers to the transaction which the taxpayers “could have done and, in my opinion, would, but for the tax reasons, have done.”<sup>112</sup> In that case he suggested the benchmark to be “a direct borrowing of [Canadian]\$ ...”.<sup>113</sup>

The Canadian courts have, however, yet to grapple entirely with the issue of “what if the taxpayer would not have entered into any other transaction?” “What if no benchmark can be established?” This matter was raised in *McNichol*. The Court found that, in essence, the tax benefit to the taxpayers was the difference in tax payable had the taxpayers (i) received the subject distribution of their interest in Bec Company as taxable dividends instead of (ii) disposing of their shares to a third party, B Company, and in return receiving a concessionally taxed capital gain.<sup>114</sup> Bonner T.C.J. asserted that it “cannot be said that the standard against which reduction is to be measured is nil on the basis that, absent a sale of shares, no tax would have been payable.”<sup>115</sup> The rejection of this argument was, however, based on the particular facts before the Court. Bonner T.C.J. found that “doing nothing was never in the realm of the possible, for their goal, present throughout, was the realization of the economic value of their shares, which value was derived from the accumulated surplus of Bec and nothing else.”<sup>116</sup> On the facts he found that the taxpayers’ “choice was between distribution of that accumulated surplus by way of liquidating dividend and sale of the shares and in choosing the latter they chose a transaction that resulted in a tax benefit within the subsection 245(1) definition.”<sup>117</sup>

This issue was more squarely raised in *Canada Trustco*. Briefly, the arrangement under consideration involved the taxpayer, Canada Trustco Mortgages Company (“CTM Co.”), purchasing from TL Co. trailers that TL Co. was leasing to other third parties. This would allow CTM Co. to depreciate the trailers and deduct the interest incurred in financing the arrangement. The trailers were then leased to another company and then subleased back to TL Co. The taxpayers shared the benefits of the arrangement with TL Co. via lease rentals. In this case the taxpayer had derived a tax benefit of \$31 million through the tax deferral flowing from the capital cost allowance provisions (“CCA”).

Miller J. asserted that some cases do not lend to benchmarking—what he referred to as a “comparative analysis.”<sup>118</sup> The Court suggested that this approach was not suitable where the transaction under consideration was

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112. *Ibid.*

113. *Ibid.*

114. *Ibid.* at 2108.

115. *Ibid.*

116. *Ibid.*

117. *Ibid.*

118. *Canada Trustco I*, *supra* note 107 at 2030.

not separable from its tax implications.<sup>119</sup> Where there was “no simple tax-untainted transaction to compare to”<sup>120</sup> the “comparative requirement” could not be met.<sup>121</sup> In such cases, instead of comparing the transaction with a “normative transaction,” the Court compared the “taxpayer’s position before the purported avoidance transaction” with that after the avoidance transaction.<sup>122</sup> In this case, after the subject transaction “there has been a deferral of tax compared to prior to the transaction.”<sup>123</sup> The Court went on to find that the transaction was also undertaken primarily to obtain that tax benefit.<sup>124</sup> That this was a “profitable investment in a commercial context” did “not outweigh the primary purpose of obtaining the tax benefit from the investment—the tax benefit drove the deal.”<sup>125</sup> The Court, however, ultimately concluded the GAAR did not apply because of the applicability of the exception, discussed below.

Thus Miller J. suggests that no benchmark is necessary in identifying a tax benefit. In a given case a tax benefit can exist *per se* without any need for a comparative analysis. While this approach was workable in the context of the particular facts of *Canada Trustco*, it will prove more difficult to identify a tax benefit in other cases where a benchmark cannot be established. In *Canada Trustco*<sup>126</sup> “but for” the subject transaction the taxpayer would not get the benefit of the tax deferral. However, this approach will not be workable where the tax benefit is said to be the non-derivation of income, such as in *Osborne*<sup>127</sup> and *Mochkin*,<sup>128</sup> discussed below in the context of Part IV A. Even using the approach in *Canada Trustco*<sup>129</sup> unless the taxpayer has previously derived that type of income, a comparison with the taxpayer’s position before the transaction will not identify a tax benefit. It should be added, however, that perhaps that is what Miller J. intended, i.e. that there is no tax benefit in such cases. It will be seen below that this is what the Australian courts concluded in these cases.

Duff raises a slightly different, but related, issue. He notes that “while this norm [the benchmark] may be appropriate in circumstances in which a transaction would not have been carried out but for the tax benefit, it seems less appropriate for cases in which the taxpayer might reasonably have been expected to carry out another transaction but for the tax benefit.”<sup>130</sup> This

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119. *Ibid.*

120. *Ibid.*

121. *Ibid.*

122. *Ibid.*

123. *Ibid.*

124. *Ibid.* at para. 54.

125. *Ibid.* at para. 57.

126. *Ibid.*

127. See *Osborne*, *supra* note 21.

128. See *Mochkin 1* and *Mochkin 2*, *supra* note 20.

129. See *Canada Trustco 1*, *supra* note 107.

130. Duff, “Weak-Currency,” *supra* note 4 at 238 n. 41.



issue was not raised in *McNichol*<sup>131</sup> because, as noted above, Bonner T.C.J. had concluded that only two alternatives were open to the taxpayers in that case: receive the amount as an assessable dividend or as a concessionally taxed capital gain.<sup>132</sup> However, the benchmarking process will not necessarily prove ineffective when the taxpayer might reasonably have been expected to carry out another alternative transaction but for the tax benefit. In such cases the benchmark will simply need to be modified to accommodate the alternatives available to the taxpayer. The issue will be in such cases “which benchmark will the courts use?” Will the relevant benchmark be that which would otherwise require the most tax payable? Will it be the scenario that would have most logically occurred? It is contended that the Canadian courts will adopt the latter approach given their use of a probability test (i.e. “would, but for the tax reasons”) in determining the benchmark transaction.<sup>133</sup> This does not deny that, as Bonner T.C.J. stated in *McNichol*,<sup>134</sup> in some cases difficulties will still arise in identifying the benchmark. It simply reflects the fact that the matter must be undertaken on a case by case basis.<sup>135</sup>

Another issue that arose in *OSFC*<sup>136</sup> was whether the person who receives the tax benefit must be the same person who undertook or arranged the avoidance transaction. The facts have been detailed above. The taxpayer argued that as it was not a participant in the Standard Company transactions (and Standard Company did not obtain a tax benefit from such transactions) the GAAR could not apply.<sup>137</sup> The Court rejected this argument, asserting that there was nothing in subsection 245(3) *ITA* that either expressly or impliedly required the person who obtained the tax benefit to be the same person who “undertook or arranged the transaction in question.”<sup>138</sup> In the broader scheme of section 245 *ITA*, the Court found nothing linking the actual benefit to the “person or persons undertaking or arranging the transactions.”<sup>139</sup>

## B. NON-INCLUSION OF ASSESSABLE INCOME AND ALLOWANCE OF A DEDUCTION: AUSTRALIAN GAAR

As noted above, originally “tax benefit” was defined in terms of the non-inclusion of an amount that would or might reasonably be expected to be

131. *Supra* note 15.

132. *Ibid.* at 119.

133. *Canadian Pacific*, *supra* note 4 at 178.

134. *Supra* note 15 at 119.

135. See *RMM Canadian Enterprises Inc. v. Canada* [1998] 1 C.T.C. 2300, 97 D.T.C. 302 [*RMM Canadian Enterprises Inc.* cited to C.T.C.].

136. *Supra* note 16.

137. *Ibid.* at para. 41.

138. *Ibid.*

139. *Ibid.*

included in the taxpayer's income<sup>140</sup> or the allowance of a deduction that would or might not have been expected to be allowable, but for the scheme: section 177C(1) *ITAA*. While the scope of section 177C(1) has been extended by the subsequent amendments detailed above, as discussed below it is still not comprehensive.

The Australian legislation adopts a "reasonably expected" test. The Australian courts have held that section 177C(1)(a) requires a reasonable probability, not a mere possibility, that the taxpayer would have, for example, derived the income but for the scheme.<sup>141</sup> This test requires a prediction of the events that may have occurred if the tax avoidance scheme had not been entered into and the "prediction must be sufficiently reliable for it to be regarded as reasonable."<sup>142</sup>

The difficulty that arises where no such 'benchmark' can be predicted has received fuller judicial consideration in Australia. This issue was raised in *Osborne*.<sup>143</sup> The taxpayer was a qualified valuer. The subject valuation business was conducted through two corporate trustees. The taxpayer had not previously conducted a valuation business and it was his evidence that he would not personally conduct such a business without the protection of limited liability that a corporate structure afforded. The Commissioner included the valuation income in the taxpayer's assessable income, asserting that conduct of the business through the corporate trustee was to obtain a tax benefit within, *inter alia*, Part IV A *ITAA*.

Olney J. rejected the Administrative Appeal Tribunal's finding at first instance that the conduct of the valuation business by the subject corporate trustees was to enable the taxpayer to obtain a tax benefit, namely the diversion of the taxpayer's personal services income into the family trust.<sup>144</sup> The Court so concluded because, *inter alia*, the taxpayer had not previously derived the subject valuation income.<sup>145</sup> The Court found that without a pre-existing receipt of such income there could be no "diversion" of income, nor any suggestion that the corporate trustees were established with that purpose in mind.<sup>146</sup> Olney J. stated that once it was established that the taxpayer "was not, and had never been, liable to tax on the valuation income derived by [the corporate trustee], the Tribunal's approach ... [was] no longer appropri-

140. The first limb of s. 177C(1) *ITAA*, definition of tax benefit, is now clarified by s. 177C(4) *ITAA*. This provides that a tax benefit is made within s. 177C(1)(a) *ITAA* if instead of income being included in the taxpayer's assessable income, the taxpayer makes a discount capital gain.

141. *Peabody 2*, *supra* note 8 at 4111-4112; *Peabody 3*, *supra* note 21 at 4671; *Spotless 2*, *supra* note 21 at 4807-4809; *WD & HO Wills (Australia) Pty Ltd. v. FCT* (1996), 96 A.T.C. 4223 at 4255-4256 [*WD & HO Wills*]; *CC (NSW) Pty Ltd. (in liq) v. FCT* (1997), 97 A.T.C. 4123; *Grollo Nominees Pty Ltd. v. FCT* (1997), 97 A.T.C. 4585.

142. *Peabody 3*, *supra* note 21 at 4671.

143. *Supra* note 21 at 4329-4331.

144. *Ibid.* at 4329-4330.

145. *Ibid.* at 4329-4331.

146. *Ibid.* at 4331.

ate.”<sup>147</sup> Given such facts, the Tribunal’s suggestion that, but for the scheme, the taxpayer would have derived the valuation income in his own right was erroneous and thus no tax benefit was derived from the scheme.

A similar argument also found support more recently in *Mochkin*.<sup>148</sup> The taxpayer was working in the share broking industry. In 1987 the taxpayer’s commission-sharing arrangement with a stock-broking firm was terminated and he was sued for losses stemming from defaulting clients whom he had introduced to the firm. The taxpayer subsequently entered into a similar commission-sharing arrangement with another stockbroker, P Co. Subsequently the taxpayer arranged for the trustees of his family trusts, D Co. and then L Co., to enter into a contract with P Co. (and later another stock broking group), replacing the previous contract that had been directly with the taxpayer. During these periods L Co. and D Co. employed the taxpayer and others in the conduct of their stock broking businesses. During the 1989–1997 income years the taxpayer did not receive a salary except \$80,000 from L Co. in 1990. He did, however, receive trust distributions from D Co. in 1989 and L Co. in the 1993–97 income years, but these were substantially less than the net commission income received by the trustee companies. The alleged tax avoidance scheme involved the interposition of trustee companies between the taxpayer and various stock broking firms.

The Court expressed some agreement with the taxpayer’s submission that there was no tax benefit in that case because, if the scheme had not been entered into, the taxpayer would not have carried on the stock broking business in his own right. As a consequence of the previous exposure to personal liability from his work as a stockbroker, the Court found that the taxpayer would not have conducted the stock broking business except through a limited liability company.<sup>149</sup> Thus, but for the scheme, it could not reasonably be said that the taxpayer would have conducted the business in his own right and derived the net commission income.<sup>150</sup>

It should also be noted that the Australian government has stated that it intends to amend Part IV A *ITAA* to ensure that an argument similar to that made in *Osborne*<sup>151</sup> and *Mochkin*<sup>152</sup> cannot be made.<sup>153</sup> To date, however, no such legislation has been enacted.

147. *Ibid.*

148. *Supra* note 20 at 4289–4290.

149. *Ibid.* at 4286 and 4289.

150. *Ibid.* at 4289–4290.

151. *Supra* note 21 at 4329–4331.

152. *Supra* note 20 at 4289–4290.

153. Treasurer’s Press Release, 11 November 1999, online: Treasurer of the Commonwealth of Australia <[www.treasurer.gov.au/tsr/content/pressreleases/1999/074.asp](http://www.treasurer.gov.au/tsr/content/pressreleases/1999/074.asp)>. Originally it was proposed that the amendments would be operative from this date, but now they will only operate from the date the legislation is introduced into Parliament.

As noted above, the “relevant taxpayer” is the individual who obtains the “tax benefit” stemming from the scheme: section 177D *ITAA*. The Australian courts have concluded that the “relevant taxpayer” need not be “the person, or one of the persons, who entered into or carried out the scheme” within section 177D *ITAA*.<sup>154</sup> “They might be one and the same but they need not be.”<sup>155</sup> Similarly, in the context of the final element under Part IV A, namely the requirement of a dominant purpose of obtaining a tax benefit, the Australian courts have held that it is not necessary for the taxpayer who obtains the tax benefit to have entered into the scheme with the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit: section 177D *ITAA*. Thus if the promoter of the tax avoidance scheme, rather than the taxpayer, has the requisite illegitimate purpose, that will suffice for Part IV A *ITAA* to be attracted.<sup>156</sup> This element is discussed in more detail below.

### C. EVALUATION

The notion of “tax benefit” under the Canadian GAAR provides a more appropriate and comprehensive definition of the concept.<sup>157</sup> It reflects an appreciation that tax benefits stem not only from not declaring assessable income or claiming deductions that would not otherwise be available, but also making use of any concessions that might be provided under the legislative tax framework. Advantages may be conferred through the mere deferral of tax or the avoidance or deferral of interest or penalties. Through this comprehensive definition of a tax benefit the Canadian GAAR has a broader scope than the Australian provision. Thus despite the amendments listed above, section 177C is still far from comprehensive. It does not extend to all rebates and credits.<sup>158</sup> It does not extend to the avoidance of penalties or interest and does not deal with the benefits stemming from deferral. It is, however, proposed to extend the definition of tax benefit so that it will apply generally to any reduction or deferral of tax, whether through the non-inclusion of income or allowance of a deduction, loss, rebate or credit.<sup>159</sup> To date, such proposals have not been enacted.

As the above discussion indicates, despite the use of a “but for” test under the Canadian GAAR, there is great similarity in the Canadian and Australian courts’ approaches to determining the connection between the tax benefit and the scheme. Both require a reasonable predictability that, but for the scheme, the taxpayer would not have derived the subject tax ben-

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154. *Peabody 3*, *supra* note 21 at 4668.

155. *Ibid.*

156. *Consolidated Press*, *supra* note 20 at 4360; *Vincent*, *supra* note 20 at 4761. See also *Sleight*, *supra* note 20. See *FCt v. Gregghon Investments Pty Ltd.* (1987), 87 A.T.C. 4988 regarding s. 260 *ITAA*.

157. Though it would not extend to the avoidance of tax under a foreign tax Act or other Canadian Acts other than the *ITA*: Arnold & Wilson, “Part 2” *supra* note 62 at 1154.

158. See in this regard the earlier comments in *Peabody 2*, *supra* note 8 at 4117.

159. *Supra* note 153.

efit.<sup>160</sup> Akin to the Canadian process of ‘benchmarking’, the Australian courts predict the events that may have occurred if the scheme had not been entered into and that “predication must be sufficiently reliable for it to be regarded as reasonable.”<sup>161</sup>

This point can be reiterated by considering one of the most important Australian cases on this point, *Peabody v. FCT*. The Pozzolanic group of companies was controlled by T Co. (as trustee of the Peabody Family Trust) and Mr K and his associates. The beneficiaries of the trust were the taxpayer (Mrs Peabody) and her two children. The taxpayer and her husband were the sole shareholders and directors of T Co. Mr Peabody wanted to float 50% of the group, the ‘Peabody interests,’ retaining the other 50%. The consequent need for the Peabody interests to purchase Mr K’s shares was problematic. The sale would have to be revealed in any disclosure document and tax would have been payable under section 26AAA *ITAA*<sup>162</sup> on any profit made on the sale of Mr K’s shares. These problems were avoided by using a shelf company, L Co., to purchase Mr K’s interest (through a complex financing arrangement with Westpac) and then transforming those shares into virtually worthless ‘Z-class’ shares. The public float of 50% of T Co.’s shares was a great success. The Commissioner included \$888,005 in the taxpayer’s income, this representing one third of the net capital gain that would have arisen had T Co. bought and then on-sold Mr K’s shares to the public within 12 months.

Applying the above test to these facts the full court of the Federal Court and the High Court rejected the first instance finding that Part IVA applied to the arrangement. Both the Full Court of the Federal Court and the High Court held that the scheme did not provide the taxpayer with a tax benefit within section 177C.<sup>163</sup> They found that it was not reasonably probable that, but for the scheme, T Co. would have bought Mr K’s shares as T Co. faced considerable difficulties in financing the purchase. Moreover, even if T Co. had avoided these difficulties and purchased Mr K’s shares, the taxpayer would not have any present entitlement to any portion of the profits arising from the sale of the shares. Hence, there was no reasonable expectation that, but for the scheme, this profit would flow to T Co. and, in turn, to the taxpayer.<sup>164</sup>

The Canadian courts would have come to the same conclusion when applying the Canadian “but for” test. As noted above, the benchmark transaction “is not a transaction which is theoretically possible but, practically

160. *McNichol*, *supra* note 15 at 2108; *Peabody 2*, *supra* note 8 at 4111–12; *Spotless 2*, *supra* note 21 at 4807–09; *WD & HO Wills*, *supra* note 141 at 4255–56.

161. *Peabody 2*, *ibid.* at 4671.

162. This provision rendered assessable any profit arising from the sale of property held for less than 12 months.

163. *Peabody 2*, *supra* note 8 at 4116–17; *Peabody 3*, *supra* note 21 at 4671.

164. *Ibid.* at 4671.

speaking, unlikely in the circumstances.”<sup>165</sup> It must be a transaction that the taxpayers “could have done and...would, but for the tax reasons, have done.”<sup>166</sup> For the reasons detailed above it could not be said that T Co. would have bought Mr K’s shares. Moreover, as Mrs Peabody was merely one of the beneficiaries of the trust it could not be said with the requisite certainty that “but for the tax reasons”<sup>167</sup> Mrs Peabody would have received the profits from the sale of the shares.

As noted above, the Australian courts have given some limited support to the suggestion that a tax benefit will not be capable of being identified when it cannot be shown that the taxpayer would have adopted an alternative structure if he or she could not use the scheme attacked under Part IVA *ITAA*. Perhaps, in the absence of a benchmark, the Canadian courts will also be unable to apply the GAAR in many cases. While the alternative approach adopted in *Canada Trustco Mortgage Company v. The Queen* was workable in that particular case, as discussed above it will prove more difficult to identify a tax benefit in other cases not involving a benchmark.

In both jurisdictions the relevant taxpayer, namely the person who receives the tax benefit, does not need to be the person who undertook the scheme.<sup>168</sup> In Australia this issue has been addressed in a slightly different context, namely “who must hold the sole or dominant purpose of tax avoidance?” The Australian courts have held that someone who entered into the scheme, not necessarily the relevant taxpayer, can hold the requisite dominant purpose of tax avoidance.<sup>169</sup> Similarly, in Canada the requirement under subsection 245(3) *ITA* to identify if the transaction “may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit” makes no reference to the purpose having to be that of the taxpayer. The decision in *OSFC* provides a good example of this point in the Canadian context.<sup>170</sup>

## v. Purpose of Tax Avoidance

### A. BONA FIDE PURPOSES OTHER THAN OBTAINING A TAX BENEFIT: CANADIAN GAAR

As noted above, an element of the notion of an “avoidance transaction” under subsection 245(3) *ITA* is the need to identify if the transaction “may reasonably be considered to have been undertaken or arranged primarily

165. *Canadian Pacific v. The Queen*, [2000] D.T.C. 2428 at 2431.

166. *Ibid.*

167. *Ibid.*

168. *OSFC*, *supra* note 16 at para. 41; *Peabody I*, *supra* note 19 at 4595.

169. *Consolidated Press*, *supra* note 20 at 4360; *Vincent v. FCT*, *supra* note 20 at 4761. See also *Sleight*, *supra* note 20.

170. *OSFC*, *supra* note 16 at para. 41

for *bona fide* purposes other than to obtain the tax benefit.” To some extent this element of the Canadian GAAR has already been discussed. The Courts’ conclusions in regard to this element in *OSFC Holdings* and *Canadian Pacific*<sup>171</sup> were discussed above in the context of the meaning of a series of transactions. Similarly, as this element is closely tied to the requirement of a tax benefit, to some extent it has been addressed above under that heading. Thus, this final element has been considered in the context of *McNichol* and *Canada Trustco* in the above discussion of the notion of tax benefit.

It will also be seen that this element is linked to the exemption in subsection 245(4) *ITA*. Thus as the Court noted in *OSFC*,<sup>172</sup> despite the ‘tainting’ effect of subsection 245(3) *ITA*, discussed above, it is important to identify the primary purpose of each transaction in a series as this might determine whether the “avoidance transaction would result in a misuse or abuse of the provisions of the Act” within subsection 245(4) *ITA*.

Leaving aside these factors, however, this element has been given the least consideration of all the GAAR elements in Canadian judicial statements. Nevertheless, four additional points can be made in regard to this element. First, as a glance at the legislation indicates, through the inclusion of the word “primarily,” the illegitimate purpose of obtaining the tax benefit must be weighed against *bona fide* purposes and must ultimately prevail. Thus incidental tax benefits will not trigger the GAAR. In fact the technical notes to section 245 *ITA* make it clear that even a “significant, but not primary” purpose of tax avoidance will not suffice.<sup>173</sup>

Second, the purpose is to be determined “at the time the transactions in question were undertaken. It is not a hindsight assessment, taking into account facts and circumstances that took place after the transactions were undertaken.”<sup>174</sup>

Third, in *OSFC*<sup>175</sup> the Court stressed that the primary purpose is determined on a case by case basis. In that particular case, Rothstein J.A. was assisted in identifying a primary purpose of tax avoidance through a “comparison of the amount of the estimated tax benefit to the estimated business earnings...” flowing from the transaction.<sup>176</sup> Thus in concluding the primary

171. *Canadian Pacific*, *supra* note 4 at paras. 23–26.

172. *Supra* note 16 at para. 51. See further paras. 52–54.

173. See Canada, Department of Finance, Technical Notes to Bill C-139, 30 June 1988, quoted by Duff, *Canadian Income Tax Law*, *supra* note 108 at 174.

174. *OSFC*, *supra* note 16 at para. 46. See also *Canadian Pacific*, *supra* note 4 at para.16; *Loyens*, *supra* note 51 at para. 86.

175. *Ibid.* at para. 58.

176. *Ibid.* Similarly in *Water’s Edge*, *supra* note 16 at para. 35 the Court noted that the “value of the tax loss in the hands of the appellants (all of whom were in a position to absorb it quickly) when contrasted with the income-earning prospects of the computer makes the predominant purposes of the transactions plain and obvious.... The difference between the amount paid by the appellants to acquire their partnership interest (\$320,000) and the value of the computer at that time (US\$7,000) is also indicative of the fact that first and foremost, the appellants paid to acquire a tax loss.” See also *CIT Financial Ltd. v. The Queen*, 2003 D.T.C. 1138, [2003] T.C.C. 544 at para. 31 [*CIT* cited to D.T.C.].

purpose underlying the fourth transaction was not “*bona fide* purposes other than to obtain a tax benefit,” Rothstein J.A. was assisted by considering the “significant disparity between the potential tax benefit to the appellant of about \$52 million and expected returns from the operation and disposition of the STIL II portfolio.”<sup>177</sup> However, Rothstein J.A. was cautious, adding that this factor will not always be “determinative, especially where the estimates of each are close. Further, the nature of the business aspect of the transaction must be carefully considered. The business purpose being primary cannot be ruled out simply because the tax benefit is significant.”<sup>178</sup>

Fourth, the courts have noted that subsection 245(3) *ITA* encompasses an objective test.<sup>179</sup> The reference to “reasonably” in subsection 245(3) *ITA* ensures that the conclusion is objectively determined.<sup>180</sup> Related to this point, in determining the purpose, the focus is on the transaction, rather than the taxpayer.<sup>181</sup> Subsection 245(3) *ITA* requires an analysis of whether 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 taxpayer’s intentions<sup>182</sup> and the taxpayer’s particular circumstances are irrelevant.

Duff adopts a quasi-subjective approach to this element. Duff rejects the suggestion that the focus is on the “transaction.” Instead Duff restates the test as being ‘what was the purpose of a reasonable taxpayer “in the taxpayer’s circumstances”?’<sup>183</sup> Later Duff suggests the test is ‘what are the purposes of the “*parties to the transaction*”?’<sup>184</sup> In response, four points can be made. First, as noted above in regard to the need for a tax benefit, the requirement under subsection 245(3) *ITA* to identify if the transaction “may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit” makes no reference to the purpose having to be that of the actual taxpayer, much less another party to the transaction.

Second, and flowing on from this point, contrary to Duff’s suggestion “textually” subsection 245(3) is concerned with an objective consideration of the “transaction,” not the “taxpayer” or the “parties to the transaction.”

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177. *Ibid* at para. 51.

178. *Ibid*. at para. 58.

179. *Ibid*. at para. 46; *Canadian Pacific*, *supra* note 4 at para. 16; *Loyens*, *supra* note 51 at para. 86.

180. *OSFC*, *ibid*. Compare Duff, *Canadian Income Tax Law*, *supra* note 108 at 173; Arnold & Wilson, “Part 2”, *supra* note 61 at 1157.

181. Arnold & Wilson, “Part 2” *ibid*. at 1157. But see Duff, *Canadian Income Tax Law*, *ibid*.

182. *OSFC*, *supra* note 16 at para. 46. See also *Canadian Pacific*, *supra* note 4 at para. 16; *Loyens*, *supra* note 51 at para. 86. Nevertheless it is not usual for the court to note the evidence of participants as to their primary purpose(s). For example, in *Water’s Edge*, *supra* note 16 at paras. 34-35 the Court refers to the witnesses evidence, but ultimately rejected such in favour of objective factors, noting that the Tax Court Judge believed the witnesses could not be believed “on this point.”

183. Duff, *Canadian Income Tax Law*, *supra* note 108 at 173. Duff is quoting Arnold & Wilson, “Part 2”, *supra* note 61 at 1157, however, the insertion of these words is Duff’s modification of the quote.

184. *Ibid*. at 173, n. 64.



Moreover, the inclusion of the word “for” (as opposed to “with”) in subsection 245(3) *ITA* does not require, as Duff suggests, that subsection 245(3) *ITA* be read as “transactions undertaken or arranged by the parties to the transaction for their purposes....” Again there is no reference in subsection 245(3) *ITA* to the purposes of the parties to the transaction. The transaction is the focus of the analysis.<sup>185</sup>

Third, contrary to Duff’s suggestion, “conceptually” it is possible for the transaction to be identified as being undertaken or arranged for a particular purpose “independent of the purposes of the parties to the transaction.”<sup>186</sup> This is the very point of the objective test prescribed by subsection 245(3) *ITA*. What subsection 245(3) requires is an objective consideration of the transaction to determine if, in essence, this transaction is a tax avoidance transaction. It will be seen that the ‘predication test,’ espoused in *Newton v. FCT*,<sup>187</sup> and used in Australia, operates in a similar manner focusing on the “overt acts by which [the arrangement] is implemented....” The Court in this case asserted that under the predication test we must look at the “arrangement itself and see which is its effect...irrespective of the motives of the person who made it.”<sup>188</sup> Thus it is in fact logically possible that a transaction will ‘smack’ of tax avoidance when objectively viewed, when factually the parties to the transaction subjectively held *bona fide* purposes.

Fourth, the legislation makes no reference to the “taxpayer’s circumstances.” Duff’s addition into the text of subsection 245(3) *ITA* turns a clearly objective test into a quasi-subjective test because the reasonable conclusion that needs to be drawn will need to be modified by the subjective circumstances of the taxpayer. There is no authority for this subjective gloss. Similarly, there is no authority to the subjective reference to the “parties to the transaction for their purposes....”<sup>189</sup> In this regard it should be noted that Duff recognizes the significance of adopting such a quasi-subjective approach, rather than the objective approach subsection 245(3) *ITA* prescribes. He states that:<sup>190</sup>

[T]he objectivity of a rule that considers the purposes that a taxpayer may reasonably have undertaken or arranged a transaction is different from the objectivity of a rule that considers only the purposes of a transaction (assuming that these can be defined) independent of the purposes for which the taxpayer entered into the transaction. While neither approach recognizes purely subjective intentions of a taxpayer that cannot reasonably account for the transaction undertaken or arranged, only the former allows a taxpayer to argue that non-tax purposes might not normally account for a particular transaction are in fact reasonable and *bona fide* in that taxpayer’s circumstance. [emphasis added]

185. *Ibid.*

186. *Ibid.*

187. (1958), 98 C.L.R. 1 at 8 (P.C.).

188. *Ibid.*

189. Duff, *Canadian Income Tax Law*, *supra* note 108 at 173, n. 64.

190. *Ibid.* at 173–174, fn 64.

For the reasons detailed above, subsection 245(3) *ITA* does not provide for such a quasi-subjective approach. To the contrary, the Court in *OSFC Holdings* stressed that reference would not be made to "statements of intentions."<sup>191</sup>

To conclude on this element, it might be instructive to consider a further judicial example of the Courts' determination of the requisite purpose in *Water's Edge*. Broadly, the facts in this case were similar to those in *OSFC*. The scheme promoter purchased a 98% interest in a United States partnership (K) on 13 December 1991 for \$51,500. On 20 December 1991 the taxpayers, along with three other individuals, paid \$320,000 to acquire approximately 93.5% of interests in the partnership. The same day K acquired a 50% interest in a limited partnership, ILP. K's contribution to ILP was the transfer of an IBM mainframe computer. K had bought the computer in 1982 for US\$3.7 million, however, by 1991 it had a market value of approximately US\$7,000; the computer was obsolete in North America. The computer was fully depreciated for US tax purposes. Unsuccessful efforts were made to lease the computer to, *inter alia*, various Eastern European countries. K recorded a net terminal loss of \$4,441,390 for the taxation year ending 31 December 1991. The taxpayers claimed their respective share of this loss (\$4,152,700). The taxpayer argued that as the original partners had never been subject to Canadian tax, the CCA provision had never been applied to the computer. Thus, despite the US depreciation, now that there were Canadian partners, in calculating the partnership income for Canadian tax purposes it was claimed that a CCA could be claimed on the computer's original cost.

It was not disputed that the transactions provided the taxpayer "with a substantial tax benefit. Indeed they gained access to a loss totalling \$4,152,700 (93.5% of \$4,441,390) at a cost of \$320,000, or 13 cents to the dollar...."<sup>192</sup> The issue, therefore, was whether the primary purpose underlying the avoidance transaction was obtaining the tax benefit? The Court referred to the witnesses' evidence that they were "entirely" motivated by, or that their "major motivation" was, the prospect of participating in the data processing business in Eastern Europe.<sup>193</sup> Ultimately, however, the Court rejected such in favour of objective factors, noting that the Tax Court Judge believed the witnesses could not be believed "on this point."<sup>194</sup>

Approaching the matter in a similar manner to that adopted in *OSFC Holdings Ltd. v. The Queen*,<sup>195</sup> the Court noted that the "value of the tax loss in the hands of the appellants (all of whom were in a position to absorb it quickly) when contrasted with the income-earning prospects of the computer

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191. *OSFC*, *supra* note 16 at para. 46. See also *Canadian Pacific*, *supra* note 4 at para. 16.

192. *Supra* note 16 at para. 33.

193. *Ibid.* at para. 34.

194. *Ibid.*

195. *Supra* note 16 at para. 58.

makes the predominant purposes of the transactions plain and obvious.”<sup>196</sup> The Court also noted that the “difference between the amount paid by the appellants to acquire their partnership interest (\$320,000) and the value of the computer at that time (US\$7,000) is also indicative of the fact that first and foremost, the appellants paid to acquire a tax loss....”<sup>197</sup> The Court concluded that there was<sup>198</sup>

no credible explanation for the manner in which the appellants proceeded to acquire their interest in the partnership and contribute the computer to another partnership prior to the close of its 1991 taxation year, other than the achievement of the tax benefit which they were seeking. These transactions represent one of a variety of ways (some much simpler) in which the appellants could have obtained ownership of the computer for the *bona fide* purpose that they assert. However, to trigger the terminal loss and make it available to the appellants, it was essential that the computer be acquired and disposed of in the manner chosen. The quest for the tax benefit is the only reason why the transactions unfolded as they did.

#### **B. DOMINANT PURPOSE OF OBTAINING A TAX BENEFIT: AUSTRALIAN GAAR**

The final element of Part IV A *ITAA* requires that a person, not necessarily the taxpayer, must have entered into the scheme with the sole or dominant<sup>199</sup> purpose of enabling the taxpayer to obtain a tax benefit: section 177D *ITAA*. In *Spotless* the Court asserted that the dominant purpose is the “most influential and prevailing or ruling purpose.”<sup>200</sup> Thus if the tax benefit is merely incidental to commercial concerns, section 177D *ITAA* will not apply.<sup>201</sup> The conclusion under section 177D *ITAA* must also be reasonable to draw.<sup>202</sup> Thus a conclusion that is “merely fanciful or not based on reason” will not suffice.<sup>203</sup> This purpose must exist at the time the scheme was entered into.<sup>204</sup>

The courts have held that section 177D *ITAA* requires an “objective conclusion to be drawn, having regard to the matters referred to in para. (b) of the section, but no other matters.”<sup>205</sup> The “actual subjective purpose of any relevant person is not a matter to which regard may be had in drawing the conclusion.”<sup>206</sup> Thus section 177D *ITAA* is not based upon “the fiscal

196. *Ibid.* at para. 35.

197. *Ibid.*

198. *Ibid.* at para. 36.

199. Section 177A(5) provides Part IV A may apply to a scheme involving more than one purpose where the dominant purpose is the obtaining of a tax benefit.

200. *Spotless 3*, *supra* note 21 at 5206 and 5210.

201. *Peabody 2*, *supra* note 8 at 4118; *Spotless 3*, *ibid.* at 5211–12.

202. *Hart 2*, *supra* note 20 at 4621.

203. *Ibid.*

204. See *FACT v. Consolidated Press Holdings Ltd. (No. 1)* (1999), 99 A.T.C. 4945 at 4971. Note, while generally the dominant purpose is determined at the time the scheme is entered into, in certain cases the purpose may be considered while the scheme is still being carried on: *Vincent*, *supra* note 20 at 4760; *Mochkin 2*, *supra* note 20 at 4281.

205. *Peabody 2*, *supra* note 8 at 4113.

206. *Ibid.*

awareness of a taxpayer.”<sup>207</sup> It is to be determined through an objective consideration, having regard to each and every one of the eight factors listed in section 177D(b) *ITAA*.<sup>208</sup> In regard to this latter point, in *Consolidated Press* the High Court of Australia asserted that it was not necessary for a court to refer to each of the matters in section 177D(b) *ITAA* individually. It suffices if the court takes all the specified matters into account in forming “a global assessment of purpose.”<sup>209</sup>

Part IV A *ITAA*, particularly section 177D(b)(viii) *ITAA*, has been held to embody a test that originated with section 260 *ITAA*, namely the “predication test.” Under the predication test, as espoused by Lord Denning in *Newton*, to bring the arrangement within the section you must be able to predicate—by looking at the overt acts by which it is implemented—that it was implemented in that particular way so as to avoid tax.”<sup>210</sup> If the arrangement cannot be so predicated, but rather “the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.”<sup>211</sup> In so predicating, the “arrangement itself” is examined to “see which is its effect ... irrespective of the motives of the person who made it.”<sup>212</sup> Hill J. in *Peabody* examined the Explanatory Memorandum for Part IV A *ITAA*<sup>213</sup> and found that the legislation was enacted to, *inter alia*, “restore the law to what it was thought to be after the decision of the Privy Council in *Newton v. Federal Commissioner of Taxation*.”<sup>214</sup> Accordingly, he concluded that Part IVA *ITAA* would “seldom, if ever,... [apply] where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable. Part IVA is no more applicable to such a case than was its predecessor’s, section 260.”<sup>215</sup> Hence, if the dominant purpose(s) underlying a transaction is, *inter alia*, a business or family reason, Part IVA *ITAA* will not apply.<sup>216</sup> Again, *Osborne* and *Mochkin* provide two good examples of the application of this test.

207. *Consolidated Press*, *supra* note 20 at 4360.

208. *Peabody 2*, *supra* note 8 at 4113. See also *Spotless 1*, *supra* note 21 at 4417; *Spotless 2*, *supra* note 21 at 4810; *Spotless 3*, *supra* note 21 at 5210; *WD & HO Wills*, *supra* note 141 at 4252–55; *Eastern Nitrogen*, *supra* note 20 at 4177; *Vincent*, *supra* note 20 at 4517–18; *Hart 2*, *supra* note 20 at 4621, 4623–24 and 4626; *Mochkin 2*, *supra* note 20 at 4278 and 4281–83.

209. See also *Vincent*, *supra* note 20 at 4517; *Hart 2*, *supra* note 20 at 4620; *Mochkin 2*, *supra* note 20 at 4281.

210. *Supra* note 187 at 8.

211. *Ibid*.

212. *Ibid* [emphasis in original].

213. The Treasurer, *Income Tax Laws Amendment Bill (No. 2) 1981: Explanatory Memorandum*, (Canberra, AGPS, 1981) online: Australian Taxation Office <<http://www.ato.gov.au>>.

214. *Peabody 2*, *supra* note 8 at 4110.

215. *Ibid*. at 4118.

216. *Peabody 2*, *supra* note 8; *Peabody 1*, *supra* note 19; *Peabody 3*, *supra* note 21; *WD & HO Wills*, *supra* note 141 at 4254.

The facts in *Osborne* have been detailed above. The taxpayer submitted that the use of the subject corporate trustees to conduct the valuation business was an ordinary commercial and family arrangement within the predication test. It was contended that using corporate entities to obtain the protection afforded by limited liability and to enable goodwill to accrue in an entity with perpetual succession were legitimate commercial purposes.<sup>217</sup> The taxpayer also asserted that the use of corporate structures for family reasons, such as the sharing of financial benefits and assets between spouses and the provision of financial security for the taxpayer's spouse, placed the creation and use of the corporate trustees outside the reach of both section 260 and Part IVA ITAA. The Federal Court agreed, declaring that it was lawful for the valuation business to be carried on by a company and that all aspects of the arrangement complied with the ethical standards of the valuation profession.<sup>218</sup> The Court rejected the Tribunal's suggestion that the purpose underlying the arrangement was to enable the taxpayer to obtain a tax benefit, namely the diversion of the taxpayer's personal services income into the family trust.<sup>219</sup> As the taxpayer had not previously derived the subject valuation income there could be no suggestion that the corporate trustees were established with the purpose of diverting the valuation income.<sup>220</sup>

The facts in *Mochkin*<sup>221</sup> have also been detailed above. While it was accepted that one of the taxpayer's purposes in entering into the scheme was to obtain a tax benefit,<sup>222</sup> the Courts held that a reasonable person would not conclude that the taxpayer entered into the scheme for the dominant purpose of obtaining that tax benefit. In this case the tax advantages from the scheme were subsidiary to the commercial objectives of gaining limited liability.<sup>223</sup> The taxpayer's dominant purpose in entering into the scheme was to "avoid personal exposure to the liabilities and debts which would be incurred in the conduct of the business."<sup>224</sup> "In the present case, the objective facts indicate clearly that, following the settlement of [the] claim against him, the Taxpayer was not prepared to conduct the stock-broking business on his own account. He had not merely been exposed to possible personal liability..., but had actually been required to make good defaults by his

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217. Relying on a number of s. 260 ITAA cases, such as *Newton v. FCT*, *supra* note 187 at 8; *Bayly v. FCT*, (1977), 77 A.T.C. 4045 at 4056; *Jones v. FCT* (1977), 77 A.T.C. 4058 at 4067; *Rippon*, *supra* note 6 at 4190-91.

218. *Osborne*, *supra* note 21 at 4329. See further the discussion of the *Valuation of Land Act*, Vic. 1960: *Osborne*, *supra* note 21 at 4325-27.

219. *Ibid.* at 4329-31.

220. *Ibid.*

221. *Supra* note 20.

222. That tax benefit was the use of the trustee companies to derive the net income generated by the stock-broking business and distributing such in a tax effective way to the beneficiaries of the discretionary trusts: *Mochkin 1*, *ibid.* at 4479; *Mochkin 2*, *ibid.* at 4282 and 4287.

223. *Mochkin 1*, *ibid.* at 4483; *Mochkin 2*, *ibid.* at 4282.

224. *Mochkin 1*, *ibid.* at para. 65.

clients.”<sup>225</sup> Thus it was concluded that the taxpayer’s “unwillingness to provide services on his own account after February 1988 was not tax driven, but the product of commercial imperatives.”<sup>226</sup> Another purpose was to “allow the business to build up goodwill, which could be detached from the Taxpayer’s personality and continued participation in the business.”<sup>227</sup> This conclusion was supported by the fact “the income received by [D. Co. and L. Co.] was not generated simply by the personal exertion of the Taxpayer.”<sup>228</sup> The companies provided substantial facilities and employed the services of persons other than the taxpayer in the conduct of the business.<sup>229</sup> This was not merely a “one person business.”<sup>230</sup>

One final point that requires brief consideration in regard to the legitimacy of arrangements with a dominant commercial purpose is whether making a transaction tax-effective is in itself a commercial concern. This issue arose in Australia as a consequence of comments made by Cooper J. in *Spotless 2*. The facts in this case have been detailed above. Cooper J. said that where, as in this case, the “operation of the foreign taxation laws”<sup>231</sup> when compared to the Australian taxation laws, gave rise to a higher net return after tax, tax rates were a legitimate commercial consideration that could place an arrangement outside Part IVA *ITAA*. In such a case, he asserted, the dominant “purpose is to obtain the maximum return on the money invested after the payment of all applicable costs, including tax.... [T]he dominant purpose of the taxpayers was not to obtain a tax benefit.”<sup>232</sup>

On appeal the High Court rejected this view.<sup>233</sup> The Court held that just because an arrangement bore a commercial character that did not mean that it was not tax driven.<sup>234</sup> Thus when determining the dominant purpose under section 177D *ITAA*, avoiding the payment of tax to ensure a larger commercial return is not a legitimate commercial consideration. This

225. *Mochkin 2*, *supra* note 20 at para. 81.

226. *Ibid.*

227. *Ibid.* at para. 51.

228. *Ibid.* at para. 83.

229. *Ibid.*

230. *Ibid.*

231. *Spotless 2*, *supra* note 21 at 4811.

232. *Ibid.* at 4810–12. See also Dr. Julie Cassidy, “Are Tax Schemes Legitimate Commercial Transactions? *Commissioner Taxation v. Spotless Services Ltd.* and *Commissioner of Taxation v. Spotless Finance Pty Ltd.*” (1996) 2 High Court Review 23, online: High Court Review <<http://www.bond.edu.au/law/hcr/articles/203cassidy.htm>>; Dr. Julie Cassidy, “Have the Ghosts of Section 260 Come Back to Haunt the Commissioner of Taxation?” (1997) 51 Bulletin for International Fiscal Documentation 20.

233. *Spotless 2*, *ibid.* at 5206, 5210. See also *Canada Trustco*, *supra* note 107 at para. 57.

234. *Spotless 2*, *ibid.* Note, however, that while McHugh J. agreed with this conclusion, he asserted that Part IVA would not apply merely because “a taxpayer has arranged its business or investments in a way that derives a tax benefit” (at 5212). While these comments may suggest that McHugh J. agrees with the sentiments expressed by Cooper J., arguably he is simply agreeing with Hill J. that Part IVA *ITAA* will not be attracted to commercial arrangements that have merely incidental tax benefits.

approach has been followed in subsequent cases. Thus, in *Consolidated Press* the High Court declared:

[A]s was held in *Spotless*, a person may enter into or carry out a scheme, within the meaning of Pt IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business. The fact that the overall transaction was aimed at a profit making does not make it artificial and inappropriate to observe that part of the structure of the transaction is to be explained by reference to a s 177D purpose.<sup>235</sup>

### C. EVALUATION

Initially, subsection 245(3) *ITA* was expressed in terms of “*bona fide* business purposes,”<sup>236</sup> thereby incorporating the intended ‘business purpose’ test, referred to above. However, the reference to “business” too narrowly described the arrangements that were not intended to be caught by the Canadian GAAR. In its original form, subsection 245(3) *ITA* would be inapplicable to transactions that were not carried out in the context of a business as defined in subsection 248(1) *ITA*.<sup>237</sup> Moreover, as the ultimate version of the legislation reflects, business purposes are not the only legitimate non-tax purposes that may underlie a transaction.<sup>238</sup> As the Explanatory Notes to section 245 *ITA* state, the provision was “not intended to interfere with legitimate commercial and family transactions.”<sup>239</sup> Under subsection 245(3) *ITA* “[t]he vast majority of business, family or investment transactions will not be affected by proposed section 245 since they will have *bona fide*”<sup>240</sup> non-tax purposes.”<sup>241</sup> The Australian legislation has similarly recognized the legitimacy of, *inter alia*, business and family transactions through subsection 177D(viii) *ITAA* and its incorporation of the predication test. In each case this reflects the fact that both governments were concerned to catch blatant

235. *Supra* note 20 at para. 96. See also *Hart 2*, *supra* note 20 at paras. 50–62; *Mochkin 2*, *supra* note 20 at paras. 41–49.

236. Duff, *Canadian Income Tax Law*, *supra* note 108 at 173.

237. *Ibid.*; Arnold & Wilson, “Part 2”, *supra* note 61 at 1155.

238. Brian J. Arnold, “In Praise of the Business Purpose Test” in *1987 Conference Report: Report of the Proceedings of the Thirty-Ninth Tax Conference* (Toronto: Canadian Tax Foundation, 1988) 10:1 at 10:31 [Arnold, “In Praise”].

239. Department of Finance, Report Bulletin No. 585 Extra, “Explanatory Notes: Phase One of Tax Reform” (30 June 1988) at 428 [Department of Finance, “Explanatory Notes”].

240. See Arnold & Wilson, “Part 2”, *supra* note 61 at 1156 (the notion of “*bona fide*” purposes in s. 245(3) must be intended simply to refer to genuine purposes).

241. Department of Finance, “Explanatory Notes,” *supra* note 239 at 430.

and artificial tax avoidance arrangements in contradistinction to, *inter alia*, legitimate family and business transactions.<sup>242</sup>

While subsection 245(3) *ITA* uses the term “primarily” to identify the importance of the *bona fide* purpose and the Australian subsection 177A(5) *ITAA* refers to the “dominant” purpose for the application of section 177D *ITAA*, in each case this has ensured that cases involving incidental tax benefits are not caught by either GAAR.<sup>243</sup> While in both cases the approach is an objective one,<sup>244</sup> in Australia the objective determination under section 177D *ITAA* must be made having regard to the factors listed in subsection 177D(b) *ITAA* and no other facts.<sup>245</sup> In practice, however, this is hardly a limiting factor given the breadth of subsection 177D(b) *ITAA*. In particular, paragraphs 177D(b)(vii) and (viii) *ITAA* ensure that all relevant facts are considered in the objective application of section 177D *ITAA*.

There is, however, one significant difference in the Canadian GAAR and the Australian Part IVA *ITAA*. As noted above, under paragraph 245(3)(b) *ITA* it suffices if one step in the series of transactions has as its primary concern obtaining a tax benefit. As also noted above, this is not the case under Part IVA *ITAA*. Under the Australian regime, unless a single step in the scheme itself satisfies the definition of a scheme, it will not suffice that one step is based on tax considerations.<sup>246</sup> In practice, as the above discussion of the sub-scheme approach indicates, this difference could prove crucial and lead to contrary results under the two respective legislative regimes.

## VI. Exception

### A. MISUSE OF PROVISION OR ABUSE OF THE ACT: CANADIAN GAAR

As noted above, the ‘exception’ to subsection 245(2) *ITA* is found in subsection 245(4) *ITA*. This states that subsection 245(2) *ITA* will not apply to a transaction where “it may reasonably be considered that the transaction would

242. See Department of Finance, *White Paper*, *supra* note 8 at 57; *Second Reading Speech*, *supra* note 13 and accompanying text. In Australia, both the former Commissioner of Taxation, Mr Boucher, and the then Treasurer, Mr Howard, have confirmed the embodiment of the Predication test in s. 177D *ITAA*. Mr Boucher has stated as relevant to the possible exclusion of Part IVA *ITAA* any family connection between the taxpayer and other parties to the alleged “scheme.” He also noted that commercial matters carried out for family reasons do not come within the scope of Part IVA. These comments were made at a seminar conducted by the Taxation Institute of Australia. See also Second Commissioner Nolan’s address of 15 June 1990. Similarly, the then Treasurer stated in his Second Reading speech, the arrangements of a normal business or family kind, including those of a tax planning nature will be beyond the scope of Part IVA *ITAA*. See *Second Reading Speech*, *supra* note 13 and accompanying text.

243. It has been suggested that the “sole or dominant” test is less stringent than the s. 245(3) *ITA* “primarily” requirement. See Arnold & Wilson, “Part 2,” *supra* note 61 at 1161.

244. *OSFC*, *supra* note 16 at para. 46; *Canadian Pacific*, *supra* note 4 at para. 16.

245. *Peabody 2*, *supra* note 8 at 4113–14; *Spotless 1*, *supra* note 21 at 4417; *WD & HO Wills*, *supra* note 141 at 4252–55; *Eastern Nitrogen*, *supra* note 20 at paras. 72–82; *Vincent*, *supra* note 20 at paras. 113–24; *Hart 2*, *supra* note 20 at paras. 55–58; *Mochkin 2*, *supra* note 20 at paras. 26, 41–59.

246. *Peabody 3*, *supra* note 21 at 4670. See also *Peabody 2*, *supra* note 8 at 4111.



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.” Strangely, unlike the Australian equivalent and, for that matter, the final element of the Canadian GAAR, this exception has had considerable judicial consideration. In fact, in most Canadian GAAR cases the application of the exception has been a major issue, if not *the* major issue.

Four key issues have arisen in regard to this provision in the Canadian jurisprudence. First, the very role of subsection 245(4) *ITA* was initially unclear. Is it merely an interpretative section, as was the role of the draft legislation discussed below, or is it a substantive provision? At first glance it would appear to be merely an interpretative provision. The section begins with the premise “For greater certainty....” Under this view, subsection 245(4) *ITA*:

does not create an alternative test with regard to the definition of an avoidance transaction. Instead, it indicates the proper construction of section 245 with respect to transactions that appear to be tax-motivated but that, arguably, do not produce tax results that frustrate the intention of Parliament. Thus, subsection 245(4) is a complement to the non-tax purpose test and is consistent with the general approach of a modern, as opposed to a literal, interpretation of the Act.<sup>247</sup>

Despite the phrasing of subsection 245(4) *ITA*,<sup>248</sup> the Canadian courts have treated the section as a substantive provision that provides another separate issue that must be considered under section 245 *ITA*.<sup>249</sup> This is logical in light of the effect of subsection 245(4) *ITA*. It serves to exempt from the GAAR a transaction that would otherwise be an avoidance transaction within subsection 245(2) *ITA*. To have such an effect, subsection 245(4) *ITA* must have a scope that differs from that of the charging provision subsection 245(2) *ITA*. Similarly, to have the necessary effect subsection 245(4) *ITA* must have a different scope to subsection 245(3) *ITA* and its definition of an avoidance transaction. Subsection 245(4) *ITA* must extend to transactions that, while avoidance transactions within subsection 245(3) *ITA*, were not intended by Parliament to be caught by the GAAR. Thus its scope is broader than subsection 245(3) *ITA*, having the effect of making “allowance for transactions which the legislature sought to encourage by the creation of tax benefit or incentive provisions or which, for other reasons, do no violence to the Act, read as a whole.”<sup>250</sup>

Thus in *OSFC*, Rothstein J.A. recognised that subsection 245(4) *ITA* has a substantive role and suggested that the application of the subsection entails a two stage approach: (i) identifying the relevant policy underlying

247. Dodge, *supra* note 65 at 21.

248. It has been suggested that the words “For greater certainty” add nothing to the provision. See Arnold & Wilson, “Part 2,” *supra* note 61 at 1164.

249. Compare *ibid.* at 1166.

250. *McNichol*, *supra* note 15 at 120.

the subject provision(s) or the Act as a whole and (ii) assessing on the facts if the avoidance transaction constitutes a misuse or abuse of that policy.<sup>251</sup> The Court continued with some caution, however, adding that “to deny a tax benefit where there has been strict compliance with the Act, on the grounds that the avoidance transaction constitutes a misuse or abuse, requires that the relevant policy be clear and unambiguous.”<sup>252</sup>

Second, and related to this first point, if subsection 245(4) *ITA* is a substantive provision, it needs to be determined whether it specifies a further requirement for the transaction to be caught under the GAAR or whether it provides a defence or exception. While this may seem to be merely a matter of semantics, since either way the tax benefit will not be denied if subsection 245(4) is not satisfied, the issue does relate to the primacy of the provisions and issues relating to the onus of proof. If subsection 245(4) *ITA* provides a defence, then subsection 245(2) *ITA* (which interacts with subsection 245(3) *ITA*) is still the primary provision and subsection 245(4) *ITA* provides a limited exception. Moreover, as stated in *OSFC*, as a “defence” it is the taxpayer who should continue to bear the onus of proving the necessary facts to refute the assertion “that the avoidance transaction in question results in a misuse or an abuse.”<sup>253</sup> This onus is different from the legal burden of proof that applies to any taxpayer who appeals from an assessment. In addition to the burden of showing on the balance of probabilities that the assessment was wrong, under subsection 245(4) *ITA*, once the policy underlying a provision or the Act as a whole is identified,<sup>254</sup> the taxpayer then has the “provisional”<sup>255</sup> burden of refuting the assertion that this is a misuse or abuse under subsection 245(4).<sup>256</sup>

By contrast, if subsection 245(4) *ITA* specifies additional requirements,<sup>257</sup> it may gain primacy over subsection 245(2) *ITA* and, in turn, subsections 245(2) and (3) *ITA* may be read down in light of subsection 245(4) *ITA*. This view was to some extent expressed in *Canada Trustco*. In this case Miller J. asserts that the “threshold [under subsections 245(2) and (3) *ITA*] is not particularly high” and “the GAAR emphasis” in that case should be placed on the misuse and abuse issue under subsection 245(4) *ITA*.<sup>258</sup>

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251. *OSFC*, *supra* note 16 at para. 69. See also *Donahue*, *supra* note 16 at para. 14; *Loyens*, *supra* note 51 at paras. 93, 98.

252. *OSFC*, *ibid.* at para. 69. See also *Jabin*, *supra* note 16 at para. 4; *Donahue*, *supra* note 16 at paras. 16–17; *Water's Edge*, *supra* note 16 at 48; *Loyens*, *ibid.* at para. 98; *Imperial Oil*, *supra* note 16 at paras. 38–39.

253. *Ibid.* at para. 68.

254. *Ibid.* (at which stage no onus is borne by either party).

255. Rt. Hon. Mr Justice Denning, “Presumptions and Burdens” (1945) 61 L.Q.R. 379 at 379–80.

256. *OSFC*, *supra* note 16 at para. 68. See also Arnold & Wilson, “Part 2”, *supra* note 61 at 1168.

257. *Canadian Pacific*, *supra* note 4 at para. 17 (s. 245(4) was treated as an extra requirement before the GAAR is satisfied, rather than an exception/defence). See also *Imperial Oil*, *supra* note 16 at paras. 35, 40, 67.

258. *Supra* note 107 at para. 55.

Third, should a literal interpretation or a purposive approach be adopted when determining if there has been a misuse or abuse of a provision(s) or the Act? It will be seen that some Canadian courts, in particular the Courts in *Canadian Pacific Ltd.*<sup>259</sup> and *Canada Trustco*, have resurrected the pre-GAAR literal approach found in, *inter alia*, *Shell Canada* when applying subsection 245(4) *ITA*. There are in fact two aspects to the approach adopted by these Courts. First, under this approach as long as the taxpayer satisfies the literal requirements of the relevant section the Courts will hold there is no misuse of that provision under subsection 245(4) *ITA*. Second, and related to this first point, in considering if there is such a misuse or an abuse of the Act as a whole, the legal rights/form of the transaction, not its substance, is considered. If as a matter of form the transaction accords with the provision(s)/Act, that the transaction has a contrary effect in substance is not relevant to whether there has been a compliance within subsection 245(4) *ITA*.

The facts in *Canadian Pacific* have been detailed above. Even though, as noted above, the Courts in this case concluded that there was no avoidance transaction and thus there was no need to consider subsection 245(4) *ITA*, both Bonner T.C.J., at first instance, and the Court of Appeal did examine the issue. It was argued that there was an abuse of the Act as a whole because the arrangement allowed the taxpayer to deduct payments that were purportedly interest when in fact they partially constituted principal.<sup>260</sup> Both Bonner T.C.J. and the Court of Appeal relied on the pre-GAAR decision *Shell Canada* where the literal rule and legal rights approach were used, as authority for the proposition that there was no misuse or abuse within subsection 245(4) *ITA*.<sup>261</sup> Moreover, neither Bonner T.C.J. nor the Court of Appeal would entertain the argument that there had been an abuse of the Act, adopting a legal rights/form approach to the transaction. The Courts said that under the terms of the debenture document the payments were interest, not principal.<sup>262</sup> The Courts would not recharacterize them as partially principal in the course of considering if there was an abuse of the Act.<sup>263</sup> If the reality of the arrangement had been considered, the consequent deduction of inflated interest payments was a misuse of subparagraph 20(1)(c)(i) *ITA* and the deferral of tax through the “locked-in foreign exchange gain at a preferential rate” was a misuse of the capital gains provisions.<sup>264</sup> Further, as reiterated below, such weak-currency transactions constitute an abuse of the *ITA* read as a whole. However, as the Courts refused to look at the economic

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259. *Canadian Pacific*, *supra* note 4 at para. 32–34.

260. *Ibid.* at para. 29.

261. *Ibid.* at paras. 32–34.

262. *Ibid.* at para. 30.

263. *Ibid.* at paras. 33–34.

264. Duff, “Weak-Currency,” *supra* note 4 at 239.

reality of the transactions, these views would not be entertained.

The approach in *Canadian Pacific* was recently followed in *Canada Trustco*.<sup>265</sup> Again, the facts have been detailed above. It had been argued that there was a misuse of the CCA provisions because the facts involved no real money being invested, “only a shuffling of paper.”<sup>266</sup> In considering this issue the Court began by adopting the legal rights/form approach and the literal rule, to determine if the prerequisites to the CCA had been met. The Court asserted that neither the “economic realities” of a transaction nor the “general object and spirit of the provision at issue” could supplant the clear and unambiguous terms of a provision.<sup>267</sup> Thus legal form, not economic realities, determined the deductibility of the amounts under the CCA.<sup>268</sup>

Then, in considering if under subsection 245(4) *ITA* economic realities or legal form would be considered, the Court followed *Canadian Pacific*. The Court refused to accept the argument that there had been a misuse of the CCA on the basis that it would involve recharacterizing, *inter alia*, the legal form of the transaction.<sup>269</sup> The Court reiterated that under subsection 245(4) *ITA* the “transaction must be viewed in its legal context” to determine if it is abusive.<sup>270</sup> Given (as a matter of form), that the requirements for deductibility under the CCA existed, the Court concluded there was “no misuse of the CCA provisions.”<sup>271</sup> Again, if a purposive approach was adopted in relation to subsection 245(4) *ITA* and the substance, not the form, of the transaction was considered, the circularity of the purchase and leaseback arrangement and the absence of any real capital costs to the taxpayer should have indicated that this was a misuse of the CCA provisions and an abuse of the Act as a whole.

To this end it is relevant to note a purposive approach was adopted in *OSFC*.<sup>272</sup> Rothstein J.A. asserted that what “constitutes a ‘misuse’ of the Act depends upon the *object and spirit* of the particular provision under scrutiny.”<sup>273</sup> He continued by stating that the “abuse analysis will involve a consideration of the avoidance transactions in a wider context, having regard to the provisions of the *Income Tax Act* read as a whole and the *policy* behind

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265. *Canada Trustco I*, *supra* note 107. The decision was upheld on appeal in *Canada Trustco*, *supra* note 16.

266. *Canada Trustco I*, *ibid.* at para. 69.

267. *Shell Canada*, *supra* note 4 at paras. 39–40, cited in *Canada Trustco I*, *supra* note 107 at para. 70.

268. *Canada Trustco I*, *ibid.* at paras. 69–73.

269. *Ibid.* at paras. 69, 74, 76–79.

270. *Ibid.* at para. 77.

271. *Ibid.* at para. 89.

272. *Supra* note 16 at para. 61. See also *McNichol*, *supra* note 15 at 2112–13; *Imperial Oil*, *supra* note 16 at paras. 36–37, 45; *RMM Canadian Enterprises Inc.*, *supra* note 135 at paras. 51–54; *Duncan et. al. v. The Queen*, [2001] D.T.C. 96, [2001] 2 C.T.C. 2884 [*Duncan* cited to D.T.C.].

273. Vern Krishna, *Tax Avoidance: The General Anti-Avoidance Rule*, (Toronto: Carswell, 1990) at 51 [Krishna, *Tax Avoidance*], cited in *OSFC*, *ibid.* at para. 61 [emphasis added].

them.”<sup>274</sup> It is not sufficient “merely to rely on the technical language of the particular provision or scheme of provisions.”<sup>275</sup> Further, determining the “object and spirit” or “policy” can be assisted by reference to extrinsic materials, such as “technical notes, writings, Hansard and enacting notes.”<sup>276</sup>

Rothstein J.A. rejected the taxpayer’s suggestion that in assessing misuse and abuse the literal approach that confined the court’s consideration to the “language of the provisions themselves,” as espoused in *Shell Canada* was to be applied.<sup>277</sup> The Court recognized that the literal approach would render the GAAR meaningless.<sup>278</sup> Under the literal approach as long as the taxpayer satisfies the literal requirements of the section there is no misuse of the provision. However, it is a given that the taxpayer has strictly satisfied the requirements of the provision. This is because the “GAAR is a weapon of last resort”<sup>279</sup> that can only operate when the literal requirements of a provision(s) have been met and the tax avoidance scheme is otherwise effective.<sup>280</sup> As the Court in *CIT* later reiterated, the GAAR “must be considered after the specific sections have been considered and, if possible, applied. GAAR does not subsume or encompass the other sections of the *Income Tax Act*, nor is it a substitute for them.”<sup>281</sup> Thus the courts need to first consider whether the loss, for example, can be claimed under the requisite section<sup>282</sup> and/or that no sham exists.<sup>283</sup> In addition, a specific avoidance provision may need to be considered.<sup>284</sup> It is only once these matters have been determined that the GAAR issue arises. Thus, logically, subsection 245(4) *ITA* must be concerned with the policy underlying the subject provision or Act as a whole, not whether it has literally been satisfied.

As the technical notes state, not to adopt the purposive approach to subsection 245(4) *ITA* would defeat the very “object and purpose” of section

274. *OSFC*, *ibid.* at para. 61 [emphasis added].

275. Vern Krishna, *The Fundamentals of Canadian Income Tax*, 5th ed. (Toronto: Carswell, 1995) at 1419, cited in *OSFC*, *supra* note 16 at para. 65.

276. *Ibid.* at para. 63. See also *Loyens*, *supra* note 51 at paras. 100–106 (where such extrinsic evidence helped the Court conclude there was no misuse of the object and spirit of ss. 85 and 97 as the subject transaction did not involve a conversion of business income to capital gains). Compare *Imperial Oil*, *supra* note 16 para. 49.

277. *OSFC*, *supra* note 16 at paras. 61–62.

278. *Ibid.* at paras. 63, 117.

279. *CIT*, *supra* note 176 at para. 66. See also *STB*, *supra* note 16 at para. 26; *Imperial Oil*, *supra* note 16 at para. 31; Arnold & Wilson, “Part 2,” *supra* note 61 at 1165.

280. *OSFC*, *supra* note 16 at para. 63. See also *RMM Canadian Enterprises Inc.*, *supra* note 135 at 311; *Duncan*, *supra* note 272 at 110–11; *CIT*, *ibid.* at paras. 66, 70; *Imperial Oil*, *ibid.* at para. 30.

281. *CIT*, *ibid.* at para. 71.

282. See e.g. *Water’s Edge*, *supra* note 16. Compare Arnold & Wilson, “Part 2,” *supra* note 61 at 1165.

283. See e.g. *McNichol*, *supra* note 15 at 2098. See also *RMM Canadian Enterprises Inc.*, *supra* note 135; *Michelin 2*, *supra* note 15; *CIT*, *supra* note 176 at para. 70.

284. See generally *CIT*, *ibid.* at para. 74 (the Court found there was no need to invoke the GAAR as a specific anti-avoidance provision, s. 69 applied); *RMM Canadian Enterprises Inc.*, *ibid.* (the Court found there was no need to resort to the GAAR because s. 84(2) deemed the distribution to be a dividend). See also *STB*, *supra* note 16 at para. 26; *Imperial Oil*, *supra* note 16 at para. 30.

245 *ITA*.<sup>285</sup> “Where 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 ... even though the strict words of the relevant specific provision may support the tax result sought by the taxpayer.”<sup>286</sup>

Equally, as indicated in *McNichol v. The Queen*,<sup>287</sup> the whole idea of subsection 245(4) *ITA* is clearly to consider the substance, not the legal form, of the avoidance transaction, to determine if there has been a misuse of the particular provision or an abuse of the Act as a whole. As the technical notes state, “a transaction structured to take advantage of technical provisions of the Act but which would be inconsistent with the overall purpose of these provisions would be seen as a misuse of these provisions.”<sup>288</sup> Again, it is a given that the taxpayer has as a matter of legal form satisfied the requirements of the provision, otherwise he or she would not have obtained his or her tax benefit in the first place. If the court cannot look at the substance of the transaction to determine if there is a misuse or abuse, subsection 245(4) *ITA* will again be nugatory. The approach taken to this aspect of subsection 245(4) *ITA* in cases such as *Canadian Pacific* involves the “tail wagging the dog” in the sense that the legal form will wrongly dictate if there is a misuse or abuse of relevant policy.

Moreover, these issues raise the simple question of the “relevance of the conclusions of the Supreme Court of Canada in *Shell Canada* on the basis that they reflect pre-GAAR modes of thinking that the enactment of GAAR was intended to transform.”<sup>289</sup> As Rothstein J.A. stressed in *OSFC* given that in none of the cases (such as *Shell Canada*) upon which the taxpayer relied for the literal approach did the courts consider the current version of section 245, “these statements of the Supreme Court cannot be said to apply to a misuse and abuse analysis under subsection 245(4).”<sup>290</sup>

Fourth, it will be apparent from subsection 245(4) that it has two limbs:  
 • is there a misuse<sup>291</sup> of a provision(s)<sup>292</sup> of the Act?

285. Department of Finance, “Explanatory Notes”, *supra* note 239 at 432. See Dodge, *supra* note 65, where the then Senior Assistant Deputy Minister of the Department of Finance asserted in regard to s. 245(4), the subsection “is a complement to the non-tax purpose test and is consistent with the general approach of a modern, as opposed to a literal, interpretation of the Act.” (at 21).

286. Department of Finance, “Explanatory Notes”, *ibid.* at 431–32.

287. *Supra* note 15 at 2112–13 (subsequently adopted in *RMM Canadian Enterprises Inc.*, *supra* note 144 at 2313).

288. Department of Finance, “Explanatory Notes,” *ibid.* at 432.

289. Duff, “Weak-Currency,” *supra* note 4 at 239.

290. *Supra* note 16 at para. 65.

291. See generally *Jabin*, *supra* note 16 at para. 2: the Court stated that if a particular provision is not used (in that case section 80), then it cannot be “misused”; Arnold & Wilson, “Part 2,” *supra* note 61 at 1167: “A transaction that avoids certain sections might, however, be found to be an abuse of the Act as a whole.”

292. See generally *Imperial Oil*, *supra* note 16 at para. 46 (as subsection 245(4) *ITA* refers to “provisions”, a consideration may be had to both the specific provision under consideration, and also any related provisions).

· is there an abuse of the Act when read as a whole?

In certain cases the courts have read down the second test in light of the first test and thereby rendered the former meaningless. In essence, in these cases the courts ask whether, literally, the requirements of the particular provision under which a deduction, for example, is claimed have been satisfied (i.e. applying the first limb) and if they have, the courts assert there is no abuse of the Act under the second limb. Thus the Courts in *Canadian Pacific* asserted there was no abuse of the Act as a whole because the Court in the pre-GAAR case *Shell Canada* found that such transactions were not a misuse of the particular provision allowing for the deduction of the subject interest payments, subparagraph 20(1)(c)(i) *ITA*. The Courts did not consider if the transaction was an abuse of the Act as a whole independently of their consideration of subparagraph 20(1)(c)(i) *ITA*.<sup>293</sup>

Thus the Courts' consideration of the second limb of subsection 245(4) *ITA* was dismissive, simply relying on a quotation from *Shell Canada*. The issue of an abuse of the Act should have been considered independently of the issue whether there had been a misuse of subparagraph 20(1)(c)(i) *ITA*. As Duff suggests, had this been done, arguably such "weak-currency borrowing is abusive in this more general sense, even if it does not contradict the object and spirit of paragraph 20(1)(c)."<sup>294</sup>

A similar approach to that adopted in *Canadian Pacific*<sup>295</sup> was recently confirmed in *Canada Trustco*.<sup>296</sup> Miller J. stated that a consideration of whether there is an abuse of the Act read as a whole was "an exercise in the absurd."<sup>297</sup> The Court stated that "the analysis of the misuse of the provisions and the analysis of the abuse having regard to the provisions of the Act read as a whole are inseparable."<sup>298</sup> He identified the policy of the Act as a whole, as the policy underlying the particular CCA provision.<sup>299</sup> As noted above, Miller J. concluded that given, as a matter of form, the requirements for deductibility existed, there was "no misuse of the CCA provisions."<sup>300</sup>

Contrary to this approach, in *McNichol*, Bonner T.C.J. recognized that there were two distinct tests.<sup>301</sup> The taxpayer contended that the French version of subsection 245(4) *ITA* indicated that the misuse and abuse tests were substantially the same. In rejecting this assertion the Court stated, as quoted above, that subsection 245(4) *ITA* "must have been intended to make allowance for transactions which the legislature sought to encourage by the

293. *Supra* note 4 at para. 31–32.

294. Duff, "Weak-Currency", *supra* note 4 at 239.

295. *Supra* note 4 at para. 16.

296. *Supra* note 107.

297. *Canada Trustco I*, *supra* note 107 at para. 90.

298. *Ibid.*

299. *Ibid.*

300. *Ibid.* at para. 89.

301. *Supra* note 15 at 120.

creation of tax benefit or incentive provisions or which, for other reasons, do no violence to the Act, read as a whole.”<sup>302</sup> The Court went on to conclude that the subject facts involved a misuse of sections 38 and 110.6 and an abuse of the Act as a whole.<sup>303</sup> The facts involved “a classic example of surplus stripping [and] cannot be excluded from the operation of subsection (2).... The scheme of the Act calls for the treatment of distributions to shareholders of corporate property as income...even those of a less orthodox nature than an ordinary dividend.”<sup>304</sup>

The suggestion that the misuse and abuse tests were one and the same was also rejected in *RMM Canadian Enterprises Inc.*,<sup>305</sup> *Imperial Oil*<sup>306</sup> and *OSFC*.<sup>307</sup> The Courts recognized that subsection 245(4) *ITA* involved two distinct tests. Thus, in the latter case, Rothstein J.A. stated that the “first question is whether it may reasonably be considered that any of the avoidance transactions would result in a misuse of a specific provision or provisions of the *Income Tax Act*.... If not, it is then necessary to determine whether it may reasonably be considered that any of the avoidance transactions would result in an abuse, having regard to the provisions of the Act, other than section 245, read as a whole.”<sup>308</sup> Rothstein J.A. added that the latter involves a “wider question and requires an examination of the inter-relationship of the relevant statutory provisions in context.”<sup>309</sup> This was significant in that case because Rothstein J.A. adopted a narrow construction of the policy underlying subsection 18(13) *ITA*, concluding that the taxpayer’s acquisition of the partnership interest was not a misuse of subsection 18(13),<sup>310</sup> but ultimately found that there was an abuse of the Act. Rothstein J.A. found that the “general policy of the *Income Tax Act* is against the trading of non-capital losses by corporations, subject to specific limited circumstances.”<sup>311</sup> The subject avoidance transaction had had the effect of transferring “the loss from one corporation to another through the mechanism of subsection 18(13) and the Partnership Rules. Having regard to the GAAR, these transactions violated

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302. *Ibid.* [emphasis added].

303. *Ibid.* at 121–22.

304. *Ibid.* at 120–21.

305. *Supra* note 135 at 312.

306. *Supra* note 16 at paras. 35–37, 41–43 and 48.

307. *Supra* note 16 at para. 60.

308. *Ibid.* at para. 59.

309. Krishna, *Tax Avoidance*, *supra* note 273 at 51, cited in *OSFC*, *supra* note 16 at para. 61.

310. *OSFC*, *ibid.* at paras. 76 and 79–80. Compare para. 134 (Letourneau J.A. believed there was both a misuse of s. 18(3) and an abuse of the Act as a whole. In regard to the former, it was suggested that s. 18(3) was not intended to be used by a corporation to increase the adjusted cost base of a related corporation or partnership for the purpose of selling its losses to an arm’s length corporation). See also *Water’s Edge*, *supra* note 16 at paras. 44–47, 51 (regarding this broader approach to the policy behind s. 18).

311. *OSFC*, *ibid.* at para. 98.



the general policy of the Act against the transfer of losses from one corporation to another.”<sup>312</sup>

Again, a merger of the misuse and abuse tests is contrary to Parliament’s intent. As the technical notes to subsection 245(4) state, “[A] transaction may be abusive having regard to the Act as a whole even where it might be argued, on a narrow interpretation, that it does not constitute a misuse of specific provisions.”<sup>313</sup> Parliament clearly intended two separate tests.

## B. EXPRESS CHOICES, ELECTIONS OR OPTIONS: AUSTRALIAN GAAR

As noted above, the exception to the Australian Part IVA *ITAA* is found in an exclusionary limb in the definition of “tax benefit.” Subsection 177C(2) *ITAA* excludes from the notion of tax benefit the non-inclusion of income, the allowance of a deduction, the incurring of a capital loss or allowance of a foreign tax credit that is “attributable to the making of an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option” expressly provided for by the *ITAA* or *ITAA 1997*. The section includes, however, an extra caveat that requires that the scheme was not entered into or carried out to create a circumstance or state of affairs “which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised.”

Unlike the Canadian equivalent, the meaning of this exclusionary limb has not been the subject of much comment. The language used in the provision suggests that it embodies what was referred to in the section 260 jurisprudence as the narrow,<sup>314</sup> rather than the broad, choice principle.<sup>315</sup> This is because subsection 177C(2) is confined to an agreement, etc. *expressly* provided for by the Act. It would not, therefore, extend to provisions that have an implied impact on particular arrangements; for example, provisions which merely provide for the tax consequences of particular arrangements, such as the use of a particular business entity.<sup>316</sup> In a manner akin to the nar-

312. *Ibid.* at para. 105. See also *ibid.* at para. 113. The Federal Court refused to overrule *OSFC* (*Kaulius*, *supra* note 10).

313. Department of Finance, “Explanatory Notes,” *supra* note 239 at 432.

314. In *Cridland*, Mason J. explained the choice principle “proceeds on the footing that the taxpayer is entitled to create a situation by entry into a transaction which will attract tax consequences for which the Act makes *specific* provision and that the validity of the transaction is not affected by s. 260 merely because the tax consequences which it attracts are advantageous to the taxpayer and he enters into the transaction deliberately with a view to gaining that advantage.” *Supra* note 4 at 339 [emphasis added]. Under the narrow interpretation of the choice principle, taxpayers are only so protected where the Act extends a specific choice or right to elect to have income treated in a particular way for assessment purposes. It is not sufficient that the Act recognizes entities, such as companies and trusts, for the taxpayer to legitimate his or her use of these entities under the narrow choice principle. See *e.g.* *Gulland*, *supra* note 6.

315. Under the broad interpretation of this doctrine, s. 260 could not apply where taxpayers had arranged their affairs to take advantage of the Act’s treatment of a particular arrangement or form of income (not necessarily involving a specific express provision of the Act) even though the taxpayer had entered into the arrangement with the sole or dominant purpose of attracting that tax benefit. See *e.g.* *Cridland*, *ibid.*

316. *Case W58*, *supra* note 8 at paras. 63–66.

row choice principle, however, subsection 177C(2) *prima facie* validates schemes that utilise specific choices provided under the Act, such as those that extend a choice between alternative accounting methods and trading stock elections. Beyond this, however, the meaning of “an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option” expressly provided for by the Act is uncertain.

As noted above, subsection 177C(2) includes a further caveat. Subsection 177C(2) will not exempt the tax benefit when the scheme was entered into to enable the otherwise exempt tax benefit to be attracted. Thus where taxpayers purposely enter into an arrangement to enable them to take advantage of a tax benefit extended expressly by some provision of the Act, subsection 177C(2) will not ‘exempt’ the arrangement from Part IVA. Unlike section 260, where the choice principle could operate even where the taxpayer purposely entered into the arrangement with the sole or dominant purpose of obtaining a tax benefit,<sup>317</sup> section 177C(2) will not exempt the tax benefit when the scheme was entered into to enable the tax benefit to be attracted. Thus an election, for example, under the Act will not fall outside Part IVA where the taxpayer entered into the subject arrangement with the purpose of enabling him or herself to be able to exercise that election and receive the consequent tax benefit.

### C. EVALUATION

The original version of section 245 *ITA* did not include a provision akin to the current subsection 245(4) *ITA*. Instead the Canadian Parliament simply included a purpose clause in the legislation that indicated that the purpose of the section was “to counter artificial tax avoidance.”<sup>318</sup> There was, however, concern that a purpose clause had been used instead of a preferred substantive exemption.<sup>319</sup> It was also suggested that the clause was unclear and that despite this provision the GAAR might apply to arrangements that either the Act had expressly sought to encourage or at least were consistent with the Act.<sup>320</sup> As a consequence of this concern the current version of subsection 245(4) *ITA* was enacted.

The purpose of both provisions 177C *ITA* and 245(4) *ITAA* was largely the same. While technically some transactions would be “avoidance transactions,” the Canadian Government did not mean for the GAAR to apply to those transactions that either fell in the realm of those which Parliament

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317. *Cridland*, *supra* note 4 at 339.

318. Department of Finance, “Explanatory Notes,” *supra* note 239 at 432.

319. Arnold & Wilson, “Part 2,” *supra* note 61 at 1163.

320. David C. Nathanson, “The Proposed General Anti-Avoidance Rule” in *1987 Conference Report—Report of Proceedings of the Thirty-Ninth Tax Conference* (Toronto: Canadian Tax Foundation, 1988) 9:01 at 9:23–9:26. See also Arnold, “In Praise,” *supra* note 238 at 10:31; Arnold & Wilson, “Part 2,” *ibid.* at 1163–64.

sought to encourage through concessional tax treatment or did not offend the “object and spirit” of the Act as a whole.<sup>321</sup> In this regard it will be recalled that both governments were concerned to “prevent artificial tax avoidance arrangements.”<sup>322</sup> Neither government intended to undermine their efforts to promote certain business transactions. Unlike the Australian provision, subsection 177C(2) *ITAA*, subsection 245(4) *ITA* has proven highly controversial. Much of this uncertainty has been caused by certain Canadian courts using pre-GAAR law to read down the scope of subsection 245(4) *ITA* to render the GAAR meaningless.<sup>323</sup> This is extremely concerning given that the explicit language used in subsection 245(4) *ITA* requires the courts, in applying subsection 245(4) *ITA*, to take a purposive approach. The technical notes, as quoted above, also indicate that a purposive approach and an appreciation beyond mere legal form was intended in the application of subsection 245(4) *ITA*.

Yet, as noted above, some Canadian courts, in particular the courts in *Canadian Pacific*<sup>324</sup> and *Canada Trustco*, have continued to use an outdated approach to statutory interpretation despite these legislative directives and as a consequence their interpretations have served to render subsection 245(4) *ITA* meaningless. For the reasons outlined above, the preferential approach to subsection 245(4) is for the courts (i) to adopt the prescribed purposive approach;<sup>325</sup> (ii) to look at the substance, rather than just the legal form, of the arrangements and (iii) to apply two separate tests that require consideration of a misuse of the relevant provisions or an abuse of the Act as a whole. This accords with both legislative intent and logic and has found support in certain Canadian cases, in particular in *OSFC*.

The confusion that exists in regard to subsection 245(4) *ITA* in Canadian jurisprudence may suggest that the better approach was that adopted in Australia in subsection 177C(2) *ITAA*. Perhaps it would have been preferable in Canada to simply include an exclusionary limb in the definition of tax benefit as in Australia. This would have excluded any uncertainty as to whether subsection 245(4) *ITA* was merely an interpretation section or whether it was intended to have substantive effect. Most importantly, the confusion as to what was intended to be excluded by subsection 245(4) *ITA*

321. Department of Finance, “Explanatory Notes”, *supra* note 239 at 432. See also CCRA Information Circular 88-2, “General Anti-Avoidance Rule—Section 245 of the I.T.” (21 October 1988).

322. Department of Finance, *White Paper*, *supra* note 8 at 57. In Australia the Treasurer stated that Part IVA was introduced “to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of the opportunities available for the arrangement of their affairs.” See *Second Reading Speech*, *supra* note 13 at 2684 (Mr Howard, Treasurer).

323. Compare Brian J. Arnold, “Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance” in Erlichman, ed., *Tax Avoidance in Canada: The General Anti-Avoidance Rule* (Toronto: Irwin Law, 2002) 41 at 80 [Arnold, “Reflections”].

324. *Canadian Pacific*, *supra* note 4 at paras. 32–34.

325. See especially Arnold, “Reflections,” *supra* note 323.

may have been avoided. Thus, the Australian legislation is phrased far more specifically than subsection 245(4) *ITA*. Subsection 177C(2) *ITAA* is concerned with express concessions and not concerned with the “object and spirit” of a provision(s), much less the policy underlying the Act as a whole. Hence, the language used in subsection 177C(2) *ITAA* may not have truly reflected the legislative concern in Canada to preserve arrangements that must also be in keeping with the underlying policy. Thus a properly administered subsection 245(4) *ITA* (in the sense that it is appropriately interpreted and applied by the judiciary) may be preferable in ensuring that only those transactions that were not intended to be caught by the GAAR will be exempted.

Subsection 177C(2) has as a preferential feature to subsection 245(4) the reference to the taxpayer’s intentions as a relevant consideration to its applicability. While subsection 177C(2) will not exempt the tax benefit where taxpayers purposely enter into an arrangement to enable them to take advantage of a tax benefit extended expressly by some provision of the Act, subsection 245(4) can, dependent upon which of the above approaches is adopted by the court, be invoked when the court finds that the transactions were structured to attract the tax benefit. Thus in *Canada Trustco*<sup>326</sup> the Court concluded the transactions were structured to attract the relevant tax benefits, yet the taxpayer was nevertheless able to enjoy the exempting benefits of subsection 245(4).<sup>327</sup>

Ultimately, perhaps the so-called failure of subsection 245(4) comes down to the fact that it is too amorphous for the judiciary to apply. Thus, as suggested by Miller J. in *Canada Trustco*, is it “an exercise in the absurd”<sup>328</sup> to ask a court to consider whether there is an abuse of the Act read as a whole. Miller J. continued:

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326. *Supra* note 107 at paras. 54 and 57.

327. *Ibid.* at paras. 54, 89. See also *Imperial Oil*, *supra* note 16; *Canadian Pacific*, *supra* note 4 at paras. 19, 34 (the Courts similarly concluded that the subject “weak-currency borrowing” arrangement was entered into for tax reasons, but was not a misuse or abuse within s. 245(4)).

328. *Canada Trustco*, *ibid.* at para. 90.

What this analysis highlights is the difficulty and risk in determining tax issues based on policy. Certainly GAAR invites such an approach, and the Federal Court of Appeal has made it clear that the only way to determine if there has been a misuse or abuse is to start with the identification of a clear and unambiguous policy. No clear and unambiguous policy—no application of GAAR. But at what level do we seek policy? And, as previously mentioned, do “policy,” “object and spirit” and “intended use” all mean the same thing? Is there a policy behind each particular provision, a policy behind a scheme involving several provisions, a policy behind the Act itself? Is the policy fiscal? Is the policy economic? Is the policy simply a regurgitation of the rules? Does the identification of policy require a deeper delving into the *raison d’être* of those rules? How deep do we dig? The success or failure of the application of GAAR left to the Court’s finding of a clear and unambiguous policy inevitably invites uncertainty. That is simply the nature of the GAAR legislation in relying upon such terms as misuse and abuse. As many have stated before, this is tax legislation to be applied with utmost caution as it directs the Court to ascertain the Government’s intention and then rely on that ascertainment to override legislation. This is quite a different kettle of fish from the accepted approach to statutory interpretation where policy might be sought to assist in understanding legislation. Under GAAR, policy can displace the legislation.<sup>329</sup>

In contrast, the Canadian courts are not ill equipped to undertake this task; “it is simply asking the courts to perform what is quintessentially the judicial function.”<sup>330</sup> The interpretation of provisions having regard to the object and spirit of the legislation is something with which the Canadian courts are familiar.<sup>331</sup> To this end it is suggested that the Canadian subsection 245(4) is far from unworkable as the approach of the court in *OSFC* indicates. As noted above, in *OSFC* Rothstein J.A. said the application of subsection 245(4) entails a two stage approach: (i) identifying the relevant policy underlying the subject provision(s) or the Act as a whole and (ii) assessing on the facts if the avoidance transaction constitutes a misuse or abuse of that policy.<sup>332</sup> As noted above, the Court asserted that at the first stage there is no burden of proof borne by either party.<sup>333</sup> The task is for the court to identify the relevant underlying policy. It is nevertheless expected that the Minister will refer to any extrinsic materials that may assist the court in identifying the relevant policy. The taxpayer then has the onus of proving the

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329. *Ibid.* at para. 91. See generally Arnold & Wilson, “Part 2,” *supra* note 61 at 1164; Arnold, “Anti-Avoidance,” *supra* note 4 at 498–511. Arnold suggests that one aspect of the problem lies in the reference to “policy” as opposed to “statutory scheme” (at 498). Arnold suggests that Miller J. wrongly believes that under s. 245(4) the courts are being asked to determine the relevant underlying tax policy as opposed to simply asking if the subject transaction is contrary to the “object and spirit” of the legislation—what Arnold refers to as the “statutory scheme” (at 501–502). To this end it is suggested that the GAAR be amended so that it is clear that an avoidance transaction involves a misuse or abuse within s. 245(4) if it “contravenes the relevant statutory scheme, not the underlying policy” (at 511).

330. Arnold, “Reflections,” *supra* note 323 at 79.

331. Compare Arnold and Wilson, “Part 2,” *supra* note 61 at 1168; Arnold, “Anti-Avoidance,” *supra* note 4 at 501.

332. *Supra* note 16 at para. 67. See also *Loyens*, *supra* note 51 at paras. 93, 98.

333. *OSFC*, *ibid.* at para. 68.

necessary facts to refute the assertion "that the avoidance transaction in question results in a misuse or an abuse."<sup>334</sup> This does not seem a process of folly, as Miller J. suggests.

## VII. Conclusion

THERE ARE MANY FEATURES of the Canadian GAAR that are to commend it when compared to the Australian Part IVA. In particular, from the perspective of those who oppose tax avoidance, the ability for the GAAR to apply to a transaction that is connected to another transaction that has as its primary purpose tax avoidance is preferable to the requirement that the scheme as a whole be based upon tax avoidance, as under the Australian regime. Equally, "tax benefit" is more comprehensively defined under the Canadian GAAR, reflecting an appreciation of the various ways that clever constructors of arrangements may attract tax benefits.

However, the divisive approach of the Canadian judiciary to subsection 245(4) *ITA* could prove to be its undoing. For the reasons outlined above, the approach adopted in relation to, *inter alia*, subsection 245(4) *ITA* in *Canadian Pacific*<sup>335</sup> is flawed, and it is disturbing that it has been followed in recent cases such as *Canada Trustco*. It is concerning that despite the most clear language of section 245 *ITA* and, at least the clear policy underlying it, some Canadian courts seem intent on rendering it meaningless by relying on the pre-GAAR case law which section 245 was intended legislatively to overrule.<sup>336</sup> The role the judiciary has taken in this area is particularly relevant when one considers Arnold's suggestion that if the courts adopted a purposive interpretation of the Act, as they should under modern Canadian statutory interpretation, the GAAR would not be necessary. It is peculiar that some members of the Canadian courts seem intent on obstructing a clearly thought out policy against tax avoidance.<sup>337</sup> In Australia's tax history there have been suggestions that members of the judiciary have done just the same for self-serving reasons, but in Canada there are no such allegations of impropriety. So why are the Canadian courts doing this? Do they really think their task is insurmountable, as suggested by Miller J. in *Canada Trustco*?<sup>338</sup> Or is Canadian judicial thought so ingrained with the literal approach

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334. *Ibid.*

335. *Supra* note 4 at paras. 32-34.

336. Compare Arnold, "Reflections", *supra* note 323 at 80; Arnold, "Anti-Avoidance", *supra* note 4 at 510.

337. Compare Arnold, "Anti-Avoidance," *ibid.* at 491, 510. Arnold suggests that the GAAR should be amended "in a targeted fashion to inform the courts that their interpretation of the existing GAAR is not in accordance with the intention of Parliament" (at 510). See *ibid.* at 510-11, for a discussion of the suggested amendments.

338. *Supra* note 107 at para. 90.

espoused in *IRC v. Duke of Westminster*<sup>339</sup> that, even though it has been rejected in the United Kingdom,<sup>340</sup> the Canadian courts cannot break free, even in the face of clear legislative intent?<sup>341</sup> If this literal/form approach had only been adopted by one 'radical' court, there would be no need for great concern. However, when the 'negative' approach in *Canadian Pacific*<sup>342</sup> has been recently subsequently followed, despite great criticism, in cases such as *Canada Trustco*,<sup>343</sup> it is cause for concern for those who oppose tax avoidance in Canada.

Despite this gloomy conclusion on the Canadian GAAR, as detailed above, the Australian legislature could nevertheless learn from the Canadian experience. In particular, the Canadian transaction within a series approach would catch scenarios where one step is inserted into a transaction to attract tax benefits. Moreover, if the judicial inconsistencies to subsection 245(4) *ITA* can be overcome, the subsection's reference to the policy underlying the specific provision and the Act as a whole might serve to accord with Parliamentary intention in Australia and only subject the Australian GAAR to artificial tax avoidance arrangements not intended to be benefited under *ITAA* or *ITAA 1997*.

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339. [1936] A.C. 1, 19 T.C. 490.

340. See *Inland Revenue Commissioners v. McGuckian*, [1997] 1 W.L.R. 991 at para. 25 (H.L.), [1997] 3 All E.R. 817; *W.T. Ramsay Ltd. v. Inland Revenue Commissioners*, [1982] A.C. 300, 54 T.C. 101 at 316-17 (H.L.) [cited to A.C.].

341. See generally Arnold, "Reflections," *supra* note 323.

342. *Supra* note 4 at paras. 32-34.

343. *Supra* note 107 at para. 90.

