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The General Anti-Avoidance Rule: Are We Moving Away From Consistency, Certainty and Predictability

The General Anti-Avoidance Rule (the "GAAR"), contained in section 245 of the *Income Tax Act (Canada)* (the "*Act*"), is a provision which allows the Canada Revenue Agency ("CRA") to redetermine the tax consequences of a transaction(s) entered into by a taxpayer in an effort to deny the tax benefit(s) otherwise enjoyed by the taxpayer as a result of entering into the impugned transaction(s).

The GAAR, characterized as a provision of last resort, only applies where the taxpayer has complied with the Act and reported the impugned transaction(s) accordingly. As such, the GAAR lends itself to a measure of uncertainty for taxpayers, who will have fully complied with the law, yet find themselves on the receiving end of an unfavourable reassessment from CRA.

In order for CRA to reassess a taxpayer based on the GAAR, the following three tests must be met:

1. The taxpayer must have enjoyed a **tax benefit** as a result of the impugned transaction(s). The Supreme Court considered the definition of tax benefit in subsection 245(1) of the Act and stated:

   > If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. In some other instances, it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement.[1]

   Based on the foregoing it should come as no surprise that in most cases where business deals are completed in a tax-efficient manner the existence of a tax benefit will be obvious.

2. In respect of the impugned transaction(s), the taxpayer must have entered into an **avoidance transaction**, as this term is defined in subsection 245(3) of the *Act*. In respect of this part of the GAAR test, the Supreme Court stated:

   > According to s. 245(3), the GAAR does not apply to a transaction that "may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit." If there are both tax and non-tax purposes to a transaction, it must be determined whether it was reasonable to conclude that the non-tax purpose was primary. If so, the GAAR cannot be applied to deny the tax benefit.[2]

   It has been at this stage of the GAAR test, that taxpayers have been most successful in their challenges of GAAR reassessments before the Tax Court[3] subsequent to the Supreme Court's first GAAR decisions in *Canada Trustco*[4] and *Kaulius*[5].

3. The final stage of the GAAR test is a consideration of whether the avoidance transaction(s) entered into by the taxpayer, resulting in the tax benefit, was such that the taxpayer is considered to have engaged in **abusive tax avoidance**. In this respect the Supreme Court stated:

   > The heart of the analysis under s. 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case. The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The next task is to determine whether the transaction falls within or frustrates that purpose. The overall inquiry

> thus involves a mixed question of fact and law. The textual, contextual and purposive interpretation of specific provisions of the *Income Tax Act* is essentially a question of law but the application of these provisions to the facts of a case is necessarily fact-intensive.
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> This analysis will lead to a finding of abusive tax avoidance when a taxpayer relies on specific provisions of the *Income Tax Act* in order to achieve an outcome that those provisions seek to prevent. As well, abusive tax avoidance will occur when a transaction defeats the underlying rationale of the provisions that are relied upon. An abuse may also result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions. By contrast, abuse is not established where it is reasonable to conclude that an avoidance transaction under s. 245(3) was within the object, spirit or purpose of the provisions that confer the tax benefit.[6]

Recently, the Federal Court of Appeal[7] considered the avoidance transaction part of the GAAR test for the first time since the Supreme Court considered its application in *Canada Trustco* and *Kaulius*.

In *MacKay*[8], the taxpayers acquired a non-performing mortgage (the "mortgage") held against a shopping centre (the "property") from a bank. While the bank's adjusted cost base in the mortgage was approximately $16 million, the fair market value of the property was only $10 million. If the taxpayers had acquired the mortgage from the bank directly they would not been entitled to the $6 million inherent loss on the mortgage. As such, the taxpayers entered into a partnership with the bank wherein the mortgage was contributed by the bank to the Partnership. The partnership then distributed $10 million to the bank in satisfaction of their partnership interest. Part of this $10 million was paid with funds from the taxpayers, and the other part was paid with funds advanced by the bank to the partnership as a business loan. The mortgage was then cancelled and the partnership acquired the property.

At then end of the partnership's fiscal year it wrote down the adjusted cost base of the property from $16 million to $10 million, as is permitted in the Act, and the taxpayers recognized their portions of the $6 million loss.

CRA reassessed the taxpayers and denied the $6 million loss on the basis of GAAR. The tax benefit enjoyed by the taxpayers was the $6 million loss. This was not in dispute.

According to CRA, the following were avoid[]\p]\]\ance transactions: entering into the partnership by the bank, the contribution of the mortgage by the bank to the partnership, and causing the bank to remain in the partnership for more than 30 days.

Previously, the Tax Court considered there to be no avoidance transaction because the primary purpose of the series of transactions entered into by the taxpayers and the bank was not primarily motivated by tax. The court, in a judgment consistent with the previous post-Canada Trustco decisions of the Tax Court, rejected CRA's position that each individual transaction in the series must be considered independently. In this respect Campbell, J. stated:

> Determining the driving forces for undertaking a particular transaction within a series cannot be undertaken in isolation from the overall purpose of the series. While the overall purpose of the series will not be determinative, it remains one of the pertinent facts which this Court must consider in a determination of avoidance because the Court must determine if the overall purpose was the primary purpose of each transaction. Therefore while a transaction may initially present itself as one which the taxpayer has undertaken for the sole purpose of obtaining a tax benefit, its primary purpose may still be a non-tax purpose when assessed with reference to the overall series where the facts support that the dominant aim is to achieve a commercially reasonable deal in a tax effective manner.[9]

As noted above, the Tax Court's interpretation of avoidance transaction was consistent with previous post-Canada Trustco decisions of the Tax Court[10]. Furthermore, this decision was consistent with the stated policy objectives of the Supreme Court in *Canada Trustco* seeking certainty, consistency, predictability and fairness under the Act for taxpayers in the organization of their affairs.[11]

Unfortunately, the Federal Court of Appeal, in *MacKay*, expanded considerably the application and interpretation of what constitutes an avoidance transaction.

> I must respectfully disagree with Justice Campbell's interpretation of subsection 245(3). In my view, her interpretation is incorrect because it is not consistent with the language or purpose of subsection 245(3), particularly paragraph 245(3)(b). As I read paragraph 245(3)(b), it requires a determination of

> the primary purpose of any transaction (or transactions) within a series of transactions that would result in a tax benefit if the GAAR does not apply. It follows that a subset of transactions within a series of transactions is an avoidance transaction unless the subset of transactions may reasonably be considered to have been undertaken or arranged primarily for a *bona fide* purpose other than to obtain a tax benefit. In my view, the conclusion that a series of transactions was undertaken primarily for *bona fide* non-tax purposes does not preclude a
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> finding that the primary purpose of one or more steps within the series was to obtain a tax benefit.

Unless the respondents (taxpayers) in *MacKay* seek leave to appeal to the Supreme Court, and the Supreme Court agrees to hear their appeal, it is questionable whether taxpayers, in undertaking tax-efficient business deals, may rely on the guidance of the post-*Canada Trustco* decisions of the Tax Court relative to the avoidance transaction part of the GAAR test. Furthermore, if the Federal Court of Appeal's interpretation of an avoidance transaction is upheld or goes unchallenged, it is likely that most tax-efficient business deals will involve at least one avoidance transaction, such that any GAAR reassessments will stand or fall on abusive tax avoidance. If this is the case, it is unlikely any level of consistency, certainty, predictability and fairness can be achieved in the application and interpretation of the GAAR going forward.

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1. *The Queen v. Canada Trustco Mortgage Co.*, [2005] 5 C.T.C. 215 (S.C.C.) ("*Canada Trustco*"), at paragraph 20.
2. Ibid. at paragraph 27.
3. *Evans v. The Queen*, [2006] 2 C.T.C. 2009 (T.C.C.) ("*Evans*"); *Overs v. The Queen*, [2006] 3 C.T.C. 2255 (T.C.C.); *Univar Canada Ltd. v. The Queen*, [2006] 1 C.T.C. 2308 (T.C.C.); MIL (*Investments*) *SA v. The Queen*, [2006] 5 C.T.C. 2552 (T.C.C.) ("*MIL Investments*"); *McMullen v. The Queen*, [2007] 2 C.T.C. 2463 (T.C.C.) ("*McMullen*"); *MacKay et al. v. The Queen*, 2007 D.T.C. 425 (T.C.C.) ("*MacKay*").
4. Supra note 1.
5. *Mathew v. The Queen*, [2005] C.T.C. 244 (S.C.C.) ("*Kaulius*").
6. Supra note 1, at paragraphs 44-45.
7. Previously, the Federal Court of Appeal considered the abusive tax avoidance part of the GAAR test in Lipson, [2007] 3 C.T.C. 110 and *MIL Investments*, [2007] 4 C.T.C. 235.
8. *MacKay*, 2008 FCA 105.
9. *MacKay* (T.C.C.), at paragraph 63.
10. Supra note 3. In particular, see *Evans, MIL Investments and McMullen*.
11. Supra note 1, at paragraphs 1, 12, 31, 42, 50 and 61.
12. Supra note 8, at paragraph 21.