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# LITIGATION — CORPORATE TAX

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Two major themes in Canadian tax litigation over the last year and a half are the on-going saga of the application of the general anti-avoidance rule, and the response of taxpayers to the increasingly vigorous audit practices of the Canada Revenue Agency.

## GENERAL ANTI-AVOIDANCE RULE DEVELOPMENTS

In October 2005 the Supreme Court of Canada released *Canada Trustco Mortgage Co. v. R<sup>1</sup>* and *Mathew v. R<sup>2</sup>*, two long-anticipated decisions dealing with the general anti-avoidance rule (the “GAAR”) under the *Income Tax Act* (Canada) (the “ITA”). Where applicable, the GAAR denies the tax benefits arising out of a transaction that technically complies with the provisions of the ITA or a tax treaty, but that represents a misuse or abuse of the ITA or a tax treaty. Applying the GAAR to a transaction requires a series of three questions to be answered in the affirmative: (1) Did the transaction result in a “tax benefit”? (2) Is it unreasonable to consider the transaction to have been undertaken primarily for *bona fide* purposes other than to obtain the tax benefit? (3) Is it reasonable to consider that the transaction results in a misuse or abuse of the provisions of the ITA or a tax treaty?

In its decisions, the Supreme Court set out the principles or guidelines for approaching the GAAR. These principles included the following:

- The Canada Revenue Agency (the “CRA”) has the burden of establishing that an avoidance transaction was abusive, in the sense that the tax benefit achieved (absent the application of the GAAR) could not reasonably be considered to be consistent with the object, spirit or purpose of the provisions of the ITA relied on by the taxpayer.
- If it is unclear whether an avoidance transaction is abusive, the benefit of the doubt goes to the taxpayer.
- In enacting the GAAR, Parliament intended to address abusive tax avoidance, but at the same time to preserve “consistency, predictability and fairness” in tax law.
- The determination of whether or not an avoidance transaction is abusive must be made by conducting a “unified textual, contextual and purposive analysis” of the ITA provisions giving rise to the tax benefit to determine

whether the tax benefit achieved is in accordance with the object, spirit and purpose of those provisions.

- Provided a Tax Court judge has properly interpreted the provisions of the ITA in making that determination, appellate courts should not interfere with his or her decision in the absence of a palpable and overriding error.

It is noteworthy that in one of the Supreme Court judgments (*Canada Trustco*) the taxpayer was successful in quashing the CRA’s GAAR assessment, and in the other (*Mathew*) the CRA’s GAAR assessment was upheld. In both cases, the Supreme Court upheld the decisions that had been made at the Tax Court and Federal Court of Appeal levels. Both of the Supreme Court cases were decided unanimously by a full panel of the nine justices of the Supreme Court. Although the facts involved in the two cases were very different, many tax practitioners found it difficult to explain exactly why one transaction was viewed as abusive while the other was not. The general view was that the future impact of the GAAR would depend largely upon how the judges of the Tax Court would interpret and apply the GAAR in the wake of the Supreme Court decisions.

A number of GAAR cases had been held in abeyance pending release of the Supreme Court decisions, with the result that several GAAR judgments have been released by the Tax Court over the last year and a half. Two of these were recently affirmed by the Federal Court of Appeal. Of the nine Tax Court judgments released to date,<sup>3</sup> six were decided in favour of the taxpayer and three in favour of the CRA.<sup>4</sup> Unfortunately, it is even more difficult to reconcile these decisions with one another than was the case in respect of the two decisions of the Supreme Court.

The cases in which the Tax Court found the GAAR did not apply involved a Barbados financing structure (*Univar*), a private corporation surplus strip (*Evans*), a shareholder loan refinancing (*Overs*), purported treaty shopping (*MIL*), the separation of a business into two independently-owned businesses (*McMullen*) and the arm’s length acquisition of a partnership to which unrealized losses had been transferred (*MacKay*). The transactions to which the Tax Court applied the GAAR were a private corporation surplus strip (*Desmarais*), an interest deductibility transaction (markedly similar to the aforementioned shareholder loan refinancing) (*Lipson*), and a transaction designed to defer the recognition of asset sale proceeds (*CECO*).

Of these cases, the two that may be most relevant to non-residents with operations or investments in Canada are *Univar* and *MIL*, which may be briefly summarized as follows:

- **Univar.** The taxpayer (“Canco”) was a wholly-owned Canadian subsidiary of a US corporation (“USCo”). USCo had a financing subsidiary in the Netherlands (“Financeco”), to which it had on-loaned funds borrowed from a third party. In the early 1990s USCo was in an excess foreign tax credits position, while Canco had surplus cash and was underleveraged. To address this situation, Canco incorporated a subsidiary in Barbados (“Subco”), which it capitalized with borrowed and surplus funds. Subco used its capital to acquire Financeco notes from USCo. From 1995 to 1999, Subco earned interest on the Financeco notes which was characterized as active business income for the purposes of the ITA’s foreign affiliate rules. Subco paid dividends to Canco, which it received as deductible

“exempt surplus” dividends. Canco deducted the interest paid by it on the borrowed funds used to capitalize Subco. The CRA relied on the GAAR in reassessing Canco to include the interest received by Subco in Canco’s income. The Tax Court found that the transactions did not result in a tax benefit to Canco, and therefore that the GAAR did not apply. The Tax Court’s determination on this point was based on its conclusion that there was no alternative transaction contemplated by the taxpayer against which to measure the tax, or lack of tax, resulting from the transaction actually undertaken.

- **MIL Investments.** MIL was controlled by a non-resident individual who had acquired 30 per cent of the shares of Diamond Field Resources (“DFR”), a small publicly-traded Canadian mineral exploration company. In 1993, the individual transferred his shares to MIL, which at that time was a Cayman Islands company. In late 1994, DFR discovered a very large nickel deposit near Voisey’s Bay, Labrador. In 1995, MIL exchanged some of its shares in DFR for shares in Inco Limited, a large Canadian public corporation, on a tax-deferred basis, reducing MIL’s direct interest in DFR to less than 10 per cent. MIL was then continued from the Cayman Islands to Luxembourg. In 1996, Inco made a bid for all of the shares of DFR, to which MIL tendered its shares for proceeds of \$427 million. MIL claimed exemption from Canadian tax on the resulting capital gain of \$426 million under the Canada-Luxembourg tax treaty, which exempts residents of Luxembourg from Canadian tax on gains realized on the disposition of shares of a Canadian corporation provided the Luxembourg resident holds less than 10 per cent of the corporation’s shares. The Tax Court held that the GAAR did not apply because all of the transactions in the series identified by the Minister were undertaken primarily for reasons other than to obtain a tax benefit. Although, based on that finding, the Tax Court did not need to address the issue of whether or not the transactions were abusive, the Tax Court judge made some *obiter dicta* observations on the issue of abuse of a tax treaty. In his view, treaty “shopping” alone could not constitute abuse; rather, a determination of abuse could be made only by examining how the provisions of the selected treaty were used.

The CRA appealed the Tax Court’s decision to the Federal Court of Appeal. On appeal, MIL conceded that its continuance as a Luxembourg corporation was an avoidance transaction. With respect to the issue of whether the transactions were abusive, the Federal Court of Appeal held that there had been no abuse or misuse of the provisions of either the *ITA* or the Canada-Luxembourg tax treaty. In this regard, the Court stated that it had been unable to identify an object or spirit of the relevant provisions, the abuse of which would justify the departure from the plain words of those provisions. In addition, in response to the issue of whether a tax treaty should be interpreted so as to permit double non-taxation, the Court stated that the issue raised by the GAAR is the incidence of Canadian taxation, not the foregoing of revenues by foreign fiscal authorities.

Although these were two cases in which the taxpayers were successful in having GAAR assessments overturned, it would be premature to extrapolate from these two decisions that the GAAR will have particularly limited application to international structures.

The CRA has filed an appeal of the Tax Court’s decision in *MacKay*, the partnership loss case. The taxpayer has requested leave to appeal the Federal Court of Appeal’s decision in *Lipson*, the interest deductibility case, to the Supreme Court of Canada. It will be interesting to see whether the Supreme Court grants leave to hear the appeal in *Lipson* and how the Federal Court of Appeal deals with the appeal in *MacKay* in light of the Supreme Court’s clear statements that the determination of whether an avoidance transaction exists and whether tax avoidance is abusive are questions primarily within the purview of the trial judge.

The Tax Court decisions over the last year and a half are not of much assistance to either taxpayers or the CRA in predicting whether a particular transaction will be viewed as abusive. At this point, the most that can be said regarding almost any tax-motivated transaction is that it is not certain whether a GAAR challenge, if brought, would be successful. In this environment, a well-advised taxpayer may still consider the risks associated with such transactions to be outweighed by the potential benefits, particularly given the fact that the GAAR does not include any penalty provisions.

## CRA AUDIT PRACTICES

In the February 2005 federal budget, the government announced an annual \$30 million increase in audit and enforcement resources, with the specific objective of discouraging “aggressive tax planning through international transactions and, in particular, the use of tax havens.”<sup>5</sup> This was followed by the CRA’s announcement in August 2005 that it was establishing 11 new “centres of expertise” that would bring together international tax auditors and tax avoidance auditors whose mandate would be to focus on the objectives announced in the budget. In the March 2007 federal budget, the government released similar proposals as part of its “International Tax Fairness Initiative.” Some of the proposals in this initiative are aimed at extending the network of countries, both treaty and non-treaty, with which Canada has tax information exchange agreements. The announced proposals also included additional funding for CRA audit and enforcement activities.

As a result of these initiatives, we expect to continue to see increased use by the CRA of its full arsenal of audit tools, particularly in the context of audits that include international elements.

### Requirements to Provide Documents or Information

One of the audit tools relied on by the CRA with increasing regularity in recent years is its ability to issue “requirements” to obtain documents or information. The requirement provisions are quite broadly drafted. In the domestic context, the CRA may issue a requirement “for any purpose related to the administration or enforcement” of the *ITA*. In addition, the CRA can require a resident of Canada or a non-resident carrying on business in Canada to provide any foreign-based information or documents “that may be relevant to the administration or enforcement” of the *ITA*.

In the case of foreign-based information requirements, provision is made in the *ITA* for judicial review. The reviewing judge has the power to vary the requirement as the judge considers appropriate, or to set it aside if the judge is satisfied that it is unreasonable. The review provisions specifically provide that a requirement is not to be considered unreasonable merely because the documents or information sought are in the control

of a related non-resident person over whom the person served with the requirement does not have control.

A person who fails to comply substantially with a foreign-based information requirement is not permitted to subsequently use the information or documents covered by the requirement in Tax Court proceedings. In addition, as the CRA invariably notes in its requirement letters, failure to comply with either a domestic or foreign-based information requirement is an offence punishable by a fine, or a fine and a period of imprisonment.

To date the courts appear to have been quite supportive of the CRA's use of foreign-based information requirements in the course of its audit activities. Recent examples of the courts' approaches are found in the following cases:

- **1144020 Ontario Ltd. v. MNR.**<sup>6</sup> The taxpayer was a Canadian-resident corporation that owned and operated two hotels in Toronto. In computing its income, the taxpayer had deducted significant management fees, consulting fees and director's fees, all payable to non-residents of Canada. The CRA issued domestic and foreign-based information requirements to the taxpayer asking for documents and information regarding the services provided by the non-residents. The Federal Court held that the information requested was relevant to the administration and enforcement of the *ITA*, and that the foreign-based information requirements were not unreasonable.
- **Fidelity Investments Canada Ltd. v. Canada (Customs & Revenue Agency).**<sup>7</sup> The CRA was conducting a transfer pricing audit of the taxpayer, a Canadian corporation in the investment management business. The taxpayer had paid fees to US-resident corporations within the same corporate group for investment management and advisory services. The CRA issued foreign-based information requirements to the taxpayer, requiring it to produce the financial statements of the US corporations to which the fees were paid. The taxpayer applied for judicial review of the requirements on the basis that they were unreasonable either because the information requested was not relevant or required for the administration of the *ITA*, or because the information requested was highly confidential and its protection could not be guaranteed. The Federal Court concluded that the information requested was relevant to the audit of the taxpayer, and that the confidential nature of the requested information did not render the requirements unreasonable.

#### Solicitor-Client Privilege

In this climate of more vigorous CRA audit activity, the maintenance of solicitor-client privilege over sensitive documents is of particular importance to taxpayers. Taxpayers are increasingly taking steps to control the flow of communications, both internally and with their professional advisors, with respect to the tax implications of transactions the CRA is likely to audit. Specifically, taxpayers often ensure that all such communications are directly connected with the giving or receiving of tax advice being provided by a lawyer, so that such communications are, and are clearly marked as, "privileged and confidential." Two recent cases involving issues of solicitor-client privilege may be of interest in this regard.

In *Philip Services Corp. (Receiver of) v. Ontario Securities Commission*,<sup>8</sup> a corporation's external auditor had requested

and been provided with a copy of certain legal opinions. The Ontario Securities Commission determined that, in providing the opinions to its auditor, the corporation had voluntarily waived privilege over the opinions for all purposes. The Ontario Divisional Court overturned the Securities Commission decision, concluding that the provision of the opinions to the auditor was not "voluntary" since the corporation was required to provide the auditor with the legal opinions once the auditor had asked for them (on the basis that the opinions were required to permit the auditor to make the necessary examination and report required by the applicable corporate legislation). The Ontario court accepted the concept of "limited waiver," concluding that solicitor-client privilege had been waived against the auditor, but preserved against everyone else.

The applicant in *Canada (Minister of National Revenue) v. Welton Parent Inc.*<sup>9</sup> was an actuarial firm that had provided valuations to a firm of Ottawa lawyers for a large number of their clients who had used the valuations to set up offshore "health and welfare trusts." The CRA had copies of some of the legal opinions provided to the clients, and issued a requirement to the applicant to obtain information and documents relating to the trusts. The applicant claimed that the information and documents were protected by solicitor-client privilege. The Federal Court held that the applicant's documents were generally not privileged, but that, to the extent that those documents disclosed the names of the lawyers' clients, they would enable the Minister to infer the nature of the legal advice that had been provided to those clients. The Court held that, as a result, the documents were privileged to that extent.

#### OTHER DEVELOPMENTS

A number of other interesting tax cases have been decided in the last year, three of which are briefly summarized below.

In *Crown Forest Industries Limited v. The Queen*,<sup>10</sup> the Tax Court held that the taxpayer could deduct interest paid on a cash basis for tax purposes even though it used the accrual method of accounting for the interest expense for financial statement purposes. The Court held that the interest deductibility provisions of the *ITA* required only that a taxpayer account for interest on a consistent basis for tax purposes.

The characterization of foreign exchange gains and losses as being on income or capital account was at issue in *CCLI (1994) Inc. v. The Queen*.<sup>11</sup> The taxpayer was in the business of providing asset-based financing by purchasing assets from customers and then leasing them back. The leases were treated as direct financing leases under GAAP, but as operating leases for tax purposes. The taxpayer borrowed the money it used in this business from its parent corporation in US dollars. The taxpayer reported the unrealized foreign exchange gains and losses on this borrowing on income account, on the basis that it was essentially in the business of lending money. The Tax Court held that the gains and losses had to be reported on capital account, since the legal form of the transactions it entered into, and hence their characterization for tax purposes, was that of a capital acquisition and lease rather than a secured loan. The Federal Court of Appeal upheld the Tax Court's decision on this issue.

The *ITA* includes a set of rules intended to prevent trading in accrued or realized corporate losses. These rules operate by limiting the deduction of such losses following an "acquisition of control" of a corporation. To facilitate the

application of these rules, a corporation is deemed to have a taxation year-end immediately prior to an acquisition of control. Subsection 256(9) of the *ITA* deems control to be acquired at the commencement of the day on which control is acquired, rather than at the actual time of the acquisition of control, unless the corporation elects in its tax return not to have subsection 256(9) apply. In *La Survivance v. The Queen*,<sup>12</sup> the taxpayer, a public corporation, claimed an allowable business investment loss ("ABIL") in respect of a disposition by it of all of the shares of another corporation ("Target") to a private corporation ("Purchaser"). The ABIL claim was based on Target being a "Canadian-controlled private corporation" at the time the shares were sold. The taxpayer's argument, which was successful before the Federal Court of Appeal, was that subsection 256(9) deemed Purchaser to have acquired control of Target at the earliest moment of the sale day, so that Target was controlled by a private corporation at the time the sale actually occurred. It seems likely that an amendment to the *ITA* will be introduced to narrow the application of subsection 256(9) to avoid such unintended consequences. In the meantime, subsection 256(9) may provide both tax planning

opportunities and, in situations that are factually the reverse of those in *La Survivance*, potential pitfalls.

<sup>1</sup>2005 SCC 54.

<sup>2</sup>2005 SCC 55.

<sup>3</sup>*Univar Canada Ltd. v. The Queen*, 2005 TCC 723; *Evans v. The Queen*, 2005 TCC 684; *Overs v. The Queen*, 2006 TCC 26; *Desmarais v. The Queen*, 2006 TCC 44; *Lipson v. The Queen*, 2006 TCC 148, aff'd 2007 FCA 113; *CECO v. The Queen*, 2006 TCC 256; *MIL Investments S.A. v. The Queen*, 2006 TCC 460, aff'd 2007 FCA 236; *McMullen v. The Queen*, 2007 TCC 16; *Mackay v. The Queen*, 2007 TCC 94.

<sup>4</sup>In the only provincial GAAR judgment released to date, the Quebec revenue authorities were successful in having the general anti-avoidance rule under the *Taxation Act* (Quebec) applied to transactions designed to avoid provincial tax: see *Ogt Holdings Ltd. v. Quebec (Sous-ministre du Revenu)*, 2006 D.T.C. 6604 (Fr).

<sup>5</sup>Budget Plan (February 23, 2005), Chapter 4, A Fair and Competitive Tax System.

<sup>6</sup>2005 FC 813.

<sup>7</sup>2006 FC 551.

<sup>8</sup>[2005] O.J. No. 4418 (Ont. S.C.).

<sup>9</sup>2006 FC 67.

<sup>10</sup>2006 TCC 47.

<sup>11</sup>2006 TCC 240, aff'd in part, 2007 FCA 185.

<sup>12</sup>2006 FCA 129.

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