CANADIAN PETROLEUM TAX SOCIETY

CANADIAN PETROLEUM TAX JOURNAL Vol. 27, 2014-2

RECENT TAX AVOIDANCE JURISPRUDENCE[1]

Prepared for:
Canadian Petroleum Tax Society 2014 Annual Conference
by Christopher J. Montes[2]
Editorial support provided by the Taxnet Pro team of Thomson Reuters

*This article is current to June 2014

The *Income Tax Act* (Canada)[3] ("**Act**") contains a large - and growing - number of anti-avoidance rules.[4] These rules generally are intended to "backstop" other rules in the Act; that is, they are designed to prevent certain tax results that otherwise would result from the straightforward application of the main, operative provisions of the Act in circumstances where those tax results are considered undesirable or unfair by the government.

Because anti-avoidance rules are intended to be a secondary, or perhaps final, line of defence against "improper" tax results or planning, they often are drafted in very broad terms or using concepts which demand the exercise of judgment. These provisions sometimes require courts to make a determination of the taxpayer's "purpose", to allocate or determine an amount "reasonably", to determine whether the taxpayer achieved a benefit by reference to an "alternative arrangement" or to determine whether a taxpayer "misused or abused" a provision of the Act. This broad drafting places considerable discretion in the hands of the Canada Revenue Agency ("**CRA**"), and ultimately the courts, often causing a great deal of consternation for taxpayers and their advisors.

This paper is intended primarily to summarize and discuss some of the recent tax avoidance cases (*i.e.*, cases dealing with anti-avoidance rules) which are expected to be of interest to the Canadian Petroleum Tax Society's membership. This paper discusses the following six cases: *Pièces Automobiles Lecavalier Inc. v. R.*,[5] *Lehigh Cement Ltd. v. R.*,[6] *McKesson Canada Corp. v. R.*,[7] *Devon Canada Corp. v. R.*,[8] *D & D Livestock Ltd. v. R.*[9] and *Swirsky v. R.*[10]

In addition to providing a summary and discussion of the aforementioned cases, this paper also uses those cases as examples to illustrate the following points. On one hand, it often is difficult for courts to interpret and apply the anti-avoidance provisions in Act, especially those which have received little or no judicial consideration. Until a number of cases dealing with a particular rule are decided, courts often draw analogies to other rules with similar terms and expressions and borrow from the jurisprudence or CRA administrative positions relating to those other rules.[11] On the other hand, it often is difficult for taxpayers and their advisors to predict when the CRA will apply certain anti-avoidance rules and whether a court will uphold such an application. That is, while anti-avoidance provisions are important to the integrity and fairness of the tax system, their use sometimes comes at the expense of certainty and predictability. The fact that the courts, through their interpretation of anti-avoidance rules, can either increase or decrease that conflict is evident from the cases summarized and discussed below.

© The Canadian Petroleum Tax Society

Pièces Automobiles Lecavalier

In *Pièces Automobiles Lecavalier*, Ford U.S.[12] owned the shares of Greenleaf Canada Acquisitions Inc. ("**Greenleaf**") and previously had loaned Greenleaf approximately $24 million. However, Greenleaf had not done well. The shares of Greenleaf were worthless and the debt was worth only approximately $9 million. Ford U.S. wanted to sell its Greenleaf shares to realize a capital loss for U.S. tax purposes. If, prior to a sale, Ford U.S. had simply forgiven the existing debt, contributed the existing debt to Greenleaf or sold the existing debt, the debt forgiveness rules or debt parking rules would have applied in an adverse manner.[13] Prior to the sale to a purchaser, Ford U.S. subscribed for approximately $15 million of Greenleaf shares and Greenleaf immediately used the proceeds of the share subscription to repay a portion of the debt and accrued interest. Shortly thereafter, the purchaser bought the shares of Greenleaf from Ford U.S. for $1 and bought approximately $9 million of debt owing by Greenleaf. The debt was purchased at an amount in excess of 80% of the principal amount (*i.e.*, it was purchased for almost 100% of the remaining principal amount of approximately $9 million), so there was no deemed settlement under the debt parking rules, which otherwise would have resulted in the application of the debt forgiveness rules. After the purchase, Greenleaf was amalgamated with the purchaser and continued as the appellant corporation.

The CRA reassessed the appellant under the general anti-avoidance rule ("**GAAR**"), treating approximately $15 million (*i.e.*, the difference between the principal amount of the debt before and after the clean-up transactions ($24 million - $9 million)) as forgiven debt. The result under section 80 was a reduction of certain of the appellant's tax attributes and, ultimately, an income inclusion for the appellant of approximately $5.7 million.

Bédard J., of the Tax Court of Canada ("**TCC**"), dismissed the appeal and applied the GAAR. Working through the GAAR analytical framework set out and applied by the Supreme Court of Canada ("**SCC**") in past jurisprudence, the TCC considered whether there was a "tax benefit"[14] and an "avoidance transaction",[15] and then whether the transaction resulted directly or indirectly in a misuse or abuse[16] of the provisions of the Act. The appellant conceded that the non-application of section 80 was a tax benefit, but argued that there was no avoidance transaction for a number of reasons. First, the appellant argued that the debt clean-up transactions and subsequent purchase of shares were not part of the same series of transactions because the debt clean-up transactions were imposed on it by Ford U.S. The TCC found that there was insufficient evidence that the debt clean-up transactions were imposed by Ford U.S., criticizing the appellant for its failure to call a witness from Ford U.S. Second, the appellant argued that the transactions were carried out for *bona fide* purposes, namely U.S. tax considerations and other considerations relevant to Ford U.S. Once again, the TCC was not convinced that this was the case and reproached the appellant for its failure to call an expert in U.S. tax matters or a representative from Ford U.S. Interestingly, the Court did acknowledge that seeking to reduce foreign tax is a *bona fide* purpose that can prevent a transaction from being an "avoidance transaction". Ultimately, the TCC held that the debt clean-up transactions were avoidance transactions.

In arguing that the debt clean-up transactions resulted in abusive tax avoidance, the Minister asserted that the debt forgiveness rules (section 80) and the debt parking rules (section 80.01) were abused, and that paragraph 80(2)(g) in particular also was abused. The appellant made a number of arguments in response to the Minister's contention that section 80 had been abused, but surprisingly made no submissions with respect to section 80.01 and paragraph 80(2)(g). First, the appellant argued that section 80 is a detailed provision that simply did not apply on its terms. Second, the appellant argued that section 80 had two purposes, being to

© The Canadian Petroleum Tax Society

counterbalance the increase in the debtor's economic power and the creditor's bad debt deduction when a debt is forgiven, and that the second of those purposes was not frustrated in this circumstance. Third, the appellant argued that the transactions it undertook simply put it in the same position that it would have been in if Ford U.S. had capitalized it with equity, rather than debt, from the start.

The TCC began its analysis on this issue by considering the text, context and purpose of each of the provisions said to have been abused. First, the TCC noted that section 80 adjusts the tax cost and/or income of the debtor to counterbalance the economic gain that a debtor realizes when a debt is forgiven. Contrary to the appellant's argument, the TCC held that the bad debt deduction provisions were not part of the debt forgiveness scheme in section 80. Second, in considering the debt parking rules in subsections 80.01(6) to (8), the TCC found that those rules deem certain situations that effectively are debt forgiveness, but which otherwise would not be caught by the debt forgiveness rules, to be within the scope of the rules in section 80. The TCC made note of the *de minimis* exception which ensures that the rules do not apply to transactions where a debt is purchased for more than 80% of its principal amount. Finally, the TCC held that paragraph 80(2)(g) is intended to prevent a taxpayer from converting a debt into shares with a value less than the principal amount of the debt.

In the end, the TCC held that the debt clean-up transactions resulted in abusive tax avoidance because they circumvented the application of section 80 and section 80.01. The TCC found that the appellant was relieved of an obligation to pay $15 million but it maintained the tax cost and expenditures arising from that $15 million. The TCC stated that, in the alternative, it would have held that the appellant misused paragraph 80(2)(g) by proceeding in two steps (*i.e.*, subscribing for shares and then repaying debt) as opposed to one (*i.e.*, repaying the debt by issuing shares).

Despite the characteristic unpredictability of GAAR decisions, the TCC's decision in *Pièces Automobiles Lecavalier* came as a surprise to some in the tax community. The transactions in *Pièces Automobiles Lecavalier* appear to resemble - in their effect, not in their mechanics - the debt clean-up transactions sanctioned by the CRA in ATR-66.[17] In ATR-66, the CRA considered a situation where a Holdco owned the shares of an Opco and had an "underwater" debt receivable ("**Opco Note**") from the Opco. Before selling the shares of Opco to a third party purchaser, Opco incorporated a subsidiary, Subco, and Holdco transferred the Opco Note to Subco in consideration for a note ("**Subco Note**"). Holdco's capital loss on the transfer of the Opco Note was denied and the loss was added to Subco's adjusted cost base ("**ACB**") of the Opco Note.[18] Subco then was wound-up into Opco and Opco elected such that the Opco Note was deemed to be settled, without payment, at its cost amount (*i.e.*, its principal amount).[19] Holdco then sold its shares of Opco and the Subco Note (now payable by Opco to Holdco) to the third party purchaser.

(As an aside, it is worth noting that it is not possible to carry out an ATR-66 reorganization with a non-resident vendor (*i.e.*, Holdco) like Ford U.S. In that situation, the capital loss denied under paragraph 40(2)(e.1) is not added to Subco's ACB of the debt under paragraph 53(1)(f.1) because the debt is not disposed of by a "taxable Canadian corporation".[20] On the winding-up of Subco, the debt would be deemed to be settled under subsection 80.01(4) at Subco's cost amount (being the fair market value of the debt), such that the debt forgiveness rules would apply.)

In ATR-66, the CRA opined, for the following reasons, that the GAAR would not apply to the transactions described therein:

© The Canadian Petroleum Tax Society

> In the circumstances described in this ruling, the concern that might result in the application of GAAR do not exist. First, the potential for doubling up on losses (i.e. the non-capital losses of Opco and the potential capital loss inherent in the adjusted cost base of the Opco note acquired by Subco) is eliminated at the time Subco is wound up into Opco. In addition, since Opco and Holco [*sic*] are related, the decision by Holdco to forego its potential capital loss on the Opco note and avoid the application of section 80 to the non-capital losses of Opco is consistent with the policy relating to transfers of income and deductions within a related corporate group and therefore does not result in a misuse of subsection 80(3) or an abuse of the Act as a whole.

Similarly, in *Pièces Automobiles Lecavalier*, there should have been no ability to "double-up" on losses in Canada. Before the debt clean-up transactions, the accrued capital loss on the debt owing to Ford U.S. only was relevant for U.S. tax purposes, not for Canadian tax purposes. Although Ford U.S. may have obtained tax cost by acquiring Greenleaf shares for approximately $15 million in cash, thereby potentially transferring the accrued capital loss on the debt to its Greenleaf shares, the accrued capital loss on its Greenleaf shares also only would be relevant for U.S. tax purposes, not for Canadian tax purposes.[21] The TCC specifically acknowledged in its decision that the avoidance of foreign tax is not relevant for purposes of the GAAR analysis.

Although the CRA cancelled ATR-66 effective September 30, 2012, the CRA has confirmed as recently as May 7, 2014 that such cancellation does not represent a change in the CRA's view on the non-application of the GAAR to ATR-66-type transactions.[22]

Based on the foregoing, it is not entirely clear why the CRA found the transactions in *Pièces Automobiles Lecavalier* to be objectionable. From a Canadian income tax perspective, the results of the transactions in *Pièces Automobiles Lecavalier* and in ATR-66 are the same. The GAAR is supposed to enhance the fairness and integrity of the tax system, but in this case it appears to have been applied with the opposite effect.

Going forward, taxpayers who wish to engage in transactions like those in *Pièces Automobiles Lecavalier* should ensure that they have a *bona fide*, non-tax purpose for their debt clean-up transactions.[23]

Lehigh Cement

In *Lehigh Cement*, a Canadian parent corporation ("**CanCo**") borrowed money from arm's length banks and, together with its wholly-owned Canadian subsidiary corporation ("**CanSub**"), contributed the borrowed money to a U.S. limited liability corporation ("**US LLC**") for equity interests (99% and 1%, respectively) therein. US LLC loaned the money it received to a U.S. corporation ("**USCo**") in the group on an interest-bearing basis. USCo carried on an active business and the interest payments made by it presumably were deductible in computing its income for U.S. tax purposes. Accordingly, the interest income received by US LLC was recharacterized under former clause 95(2)(a)(ii)(A) (which is similar to clause 95(2)(a)(ii)(B) of the current Act) as income from an active business. This recharacterization ensured that the interest income was not taxed on a current basis as "foreign accrual property income"[24], and it also allowed US LLC to pay tax-free exempt surplus dividends with the interest income it received to CanCo and CanSub.

The Minister reassessed both CanCo and CanSub on the basis that paragraph 95(6)(b) applied to deem the acquisitions of US LLC's shares not to have occurred. Paragraph 95(6)(b) reads as follows:

© The Canadian Petroleum Tax Society

> For the purposes of this subdivision (other than section 90), ... where a person or partnership acquires or disposes of shares of the capital stock of a corporation or interests in a partnership, either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, that acquisition or disposition is deemed not to have taken place, and where the shares or partnership interests were unissued by the corporation or partnership immediately before the acquisition, those shares or partnership interests, as the case may be, are deemed not to have been issued.
>
> [Emphasis added.]

Because CanCo and CanSub were deemed not have acquired shares of US LLC, the dividends they received on those shares were not deductible under paragraph 113(1)(a).

The appellants made various arguments relating to the scope of paragraph 95(6)(b) and its application in the circumstance. First, the appellants argued that paragraph 95(6)(b) is intended only to prevent the manipulation of foreign affiliate or controlled foreign affiliate status, not to act as a "mini-GAAR" to prevent all kinds of tax avoidance. They referred to the facts that (i) there is no "misuse or abuse" requirement or other limiting language in paragraph 95(6)(b), and (ii) the application of the provision has very limited consequences. Second, the appellants argued that paragraph 95(6)(b), by its very words and context, only applies where the purpose of the *acquisition or disposition of the shares*, not the purpose of the overall series of transactions of which the acquisition or disposition of shares forms a part, is to avoid or reduce tax. As a result, the appellants argued that the interest deduction and deduction of US LLC dividends were irrelevant because they were connected to the overall series of transactions, not to the *acquisition* of US LLC shares. The appellants argued that their purpose was to reduce U.S. tax because the Canadian tax results would have been the same if they had subscribed for shares of the U.S. corporation directly, being a Canadian interest deduction for CanCo and the receipt by CanCo and CanSub of tax-free, exempt surplus dividends from USCo.

The Crown argued that the acquisition of shares was primarily motivated by tax avoidance because the Canadian interest deduction that CanCo obtained exceeded its expected return from the US LLC shares. The Crown also argued that the alternative transaction proposed by the appellants - *i.e.*, a direct subscription by CanCo for USCo shares - was not possible because it would have breached a banking covenant and it would have been impossible to pay dividends from the U.S. corporation because of the losses it had incurred.

The TCC allowed the appeal and held that paragraph 95(6)(b) did not apply. In doing so, the TCC made some key statements about the scope and interpretation of paragraph 95(6)(b). First, the TCC stated that, ultimately, only the purpose of the acquisition or disposition of shares is relevant in the determination of whether paragraph 95(6)(b) applies. However, the TCC noted that this was a question of fact to be determined based on all of the circumstances, which could include the purpose of the series of transactions of which the acquisition or disposition forms a part. (As an aside, the TCC rejected the appellants' argument that certain case law in the context of paragraph 20(1)(c) was applicable in determining the taxpayer's purpose.) Second, the TCC held that paragraph 95(6)(b) is not only intended to prevent manipulations of foreign affiliate or controlled foreign affiliate status, rejecting a number of contextual arguments made by the appellants. Finally, in determining the "tax that would otherwise be payable", the TCC rejected the view of Bell J. in *Univar Canada Ltd. v. R.*[25] that the concept was similar to a "tax benefit" in section 245. Instead, the TCC stated that

© The Canadian Petroleum Tax Society

the transaction must be compared to an alternative arrangement where the relevant acquisition or disposition has not occurred and that might reasonably have been carried out by the taxpayer. (Ironically, the TCC went on to cite comments on the concept of "tax benefit" from *Copthorne v. R.*,[26] a GAAR case, at paragraph 105.)

In the case at hand, the TCC found that the appropriate alternative arrangement was a direct subscription for USCo shares. Because the same Canadian tax results would have been obtained in the alternative arrangement, no Canadian tax was avoided. In the TCC's view, the principal purpose of the acquisition of US LLC shares was to avoid U.S. tax, not Canadian tax.

The decision was appealed to the Federal Court of Appeal ("**FCA**"). The FCA upheld the TCC's decision, finding that paragraph 95(6)(b) did not apply, but for different reasons than the TCC. In contrast to the TCC, the FCA held that paragraph 95(6)(b) only applies to prevent a manipulation of foreign affiliate or controlled foreign affiliate or related corporation status, not to prevent other tax benefits that arise from a series of transactions. In support of its position, the FCA referred to (i) the words of paragraph 95(6)(b), which do not include the expression "series of transactions", even though that expression frequently is used elsewhere in the Act, (ii) the location of the provision in the foreign affiliate section[27] of the Act and not with general provisions dealing with tax avoidance,[28] and (iii) certain other amendments that, in the FCA's view, would not make sense if paragraph 95(6)(b) were given a broader interpretation. Importantly, the FCA stated that a broad interpretation of paragraph 95(6)(b) would give the CRA an undesirable amount of discretion. In words that surely will be cited by tax planners in the future, Stratas J.A. stated:

> In this case, the Crown's oral and written submissions suggest that paragraph 95(6)(b) is capable of being applied in a variety of circumstances where a taxpayer has engaged in what the Minister considers to be abusive tax planning involving foreign corporations. Indeed, the Crown seems to believe that the paragraph can be used even if the non-resident corporation has obtained foreign affiliate status without any artificial manipulation of share ownership.
> At the same time, however, the Crown does not take the view that whenever paragraph 95(6)(b) can be applied, it will. Rather, the Crown says that paragraph 95(6)(b) will be applied only where the tax avoidance is unacceptable.
>
> Unacceptability is in the eye of the beholder. It can shift depending on one's subjective judgment and mood at the time. Using it, as the Crown suggests, to restrain the indiscriminate use of paragraph 95(6)(b) creates the spectre of similarly-situated taxpayers being treated differently for no objective reason. This would violate the principle that, absent clear legislative wording, the same legal principles should apply to all taxpayers: *Bronfman Trust v. R.*, [1987] 1 S.C.R. 32 (S.C.C.) at page 46.
>
> A hypothetical but commonly-occurring scenario illustrates this problem. Where a Canadian taxpayer borrows to buy shares in a non-resident subsidiary corporation that carries on an active business, the tax result will always exceed the commercial result. The Canadian taxpayer will be able to deduct interest on the loan and deduct the dividends. As a practical matter, the tax advantages of borrowing to buy shares in a non-resident corporation often enter into the taxpayer's decision-making.
>
> In that scenario, will paragraph 95(6)(b) always be a live issue? What would govern the Minister's discretion whether or not to apply paragraph 95(6)(b)? Unlike section 245, where

© The Canadian Petroleum Tax Society

> there is an express limiting factor on the Minister's discretion—the presence of abuse or misuse—paragraph 95(6)(b) does not contain any sort of limiting factor at all. A standard of unacceptability, even if it were open to us to invent it and insert it into paragraph 95(6)(b), is in itself unacceptable, as I have explained.
>
> Absent clear wording, I would be loath to interpret paragraph 95(6)(b) in a way that gives the Minister such a broad and ill-defined discretion—a standardless sweep—as to whether or not a tax is owing, limited only by her view of unacceptability. It would be contrary to fundamental principle. It would also promote arbitrary application, the bane of consistency, predictability and fairness.[29]

In short, the FCA stated in strong terms that paragraph 95(6)(b) only applies to prevent a manipulation of foreign affiliate or controlled foreign affiliate or related corporation status, not to prevent other tax benefits that arise from a series of transactions. The FCA noted that the Minister can only look to the acquisition or disposition of shares, not to the series of transactions of which it is a part, to detect a tax avoidance purpose in the context of paragraph 95(6)(b). The FCA ultimately concluded, based on the TCC's findings, that the purpose of the acquisition of US LLC shares was not to manipulate foreign affiliate status, so the FCA affirmed the TCC's decision that paragraph 95(6)(b) did not apply.

The FCA's decision in *Lehigh Cement* should significantly reduce uncertainty regarding the scope of paragraph 95(6)(b), especially in transactions, such as double-dips, where a Canadian corporation borrows funds and invests those funds, directly or indirectly, in shares of a foreign affiliate. As an aside, it is unclear why the CRA chose to advance this case for so long because, over the past few years, the CRA has published administrative statements stating that it will not apply paragraph 95(6)(b) or the GAAR to certain double-dip transactions.[30]

The decision in *Lehigh Cement* also provides a very clear example of the issues raised at the beginning of this paper. Paragraph 95(6)(b) is a very broadly drafted rule that applies, *inter alia*, where "...it can reasonably be considered that the principal purpose for the acquisition or disposition [of shares] is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act... ." The broad drafting of the provision demands that the court make a determination regarding the taxpayer's principal purpose. Further, the provision, on its words alone, could apply to countless situations because many tax-motivated transactions include an acquisition or disposition of shares. The Canadian government's choice of an exemption system for active business income often makes it more advantageous to operate through a foreign affiliate (and to acquire shares thereof) rather than operating, for example, through a foreign branch. Prior to the *Lehigh Cement* decision, paragraph 95(6)(b) only had been judicially considered in one other case.[31]

In their judgments, both the TCC and FCA seem to have had difficulty in determining the scope of this anti-avoidance rule. Analogies to the purpose test in paragraph 20(1)(c) and to the GAAR were drawn either by counsel or by the Court. The FCA's decision is a sensible one because it should decrease the uncertainty associated with paragraph 95(6)(b) without compromising the fairness or integrity of the tax system. The CRA can always use the GAAR to combat general tax avoidance.

© The Canadian Petroleum Tax Society

McKesson

McKesson is a recent transfer pricing decision of the TCC. Trial-level transfer pricing cases usually involve the presentation of significant amounts of evidence, including expert evidence. The evidence that was presented at the TCC is described at a high level below; it is not described in detail.

McKesson Canada Corporation ("**McKesson Canada**") was a Canadian corporation that was part of a large multinational group. McKesson Canada had significant receivables that were managed by its own internal credit department. Its receivables had a historical collection rate of 99.96% and were outstanding for approximately 32 days on average. McKesson Canada entered into a Receivables Sales Agreement with its Luxembourg parent to sell its receivables to its Luxembourg parent at a discount of 2.206% under a five-year revolving facility. McKesson Canada also entered into a Servicing Agreement with its Luxembourg parent pursuant to which McKesson Canada continued to manage the receivables in exchange for a flat fee that was paid periodically. The discount rate at which the receivables were sold reduced McKesson Canada's income for Canadian tax purposes from a positive amount to a negative amount, so it resulted in the elimination of Canadian tax.

The CRA reassessed McKesson Canada under the transfer pricing rules in paragraphs 247(2)(a) and (c) to reduce the discount rate under the Receivables Sales Agreement from 2.206% to 1.0127%, but no transfer pricing penalty was assessed. The CRA also made a secondary transfer pricing adjustment, assessing McKesson Canada for its failure to withhold under Part XIII on a dividend deemed to be paid by McKesson Canada to its Luxembourg parent.[32]

First, Boyle J. went through the transfer pricing report prepared by TD Securities which calculated the discount rate that was used in the Receivables Sales Agreement. Boyle J. criticized that report extensively, especially the assumptions made therein, and described it as an "advocacy" piece. Second, Boyle J. went through a transfer pricing report prepared for McKesson Canada by a major accounting firm at the time the CRA reviewed the transactions at issue. Again, Boyle J. criticized it extensively, describing it as "primarily a piece of advocacy work, perhaps largely made as instructed."[33] Third, Boyle J. went through the expert evidence (the appellant had two experts; the Crown had three), reviewing each expert's report in detail, assessing the reliability of each one and considering the weight to be given to each one.

Ultimately, Boyle J. dismissed the taxpayer's appeal, finding that the discount rate that was used was not one that arm's length parties would have agreed upon. At the outset of his analysis, Boyle J. set out the principles from the SCC's transfer pricing decision in *GlaxoSmithKline v. R.*[34] and noted that, even though *GlaxoSmithKline* was interpreting a differently-worded transfer pricing provision, the principles set out therein were applicable in interpreting subsection 247(2).[35] Based on his own assessment of the expert evidence, Boyle J. concluded that arm's length parties would have agreed to a discount rate between 0.959% and 1.17%. Therefore, he concluded that the Minister's assumption that the discount rate between arm's length parties would have been no greater than 1.0127% was not demolished. Interestingly, Boyle J. stated that it was not appropriate for a court to cause the CRA to reassess at the high end of the range because doing so would reward "overreaching" taxpayers and would encourage frequent use of the courts.

As a result of the TCC's decision with respect to the primary transfer pricing adjustment, a dividend was deemed to be paid by McKesson Canada to its Luxembourg parent. Another issue in the case was whether the CRA's Part XIII assessment of McKesson Canada for its failure to withhold tax on the deemed dividend was too late, as it was not within five years of the end of the relevant taxation year.[36] McKesson Canada argued that

© The Canadian Petroleum Tax Society

the secondary transfer pricing adjustment assessment was prohibited by Article 9 of the Canada-Luxembourg Treaty,[37] the relevant parts of which read as follows:

> 1. Where ... an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, ... and ... conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any income which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the income of that enterprise and taxed accordingly.
>
> ...
>
> 3. A Contracting State shall not change the income of an enterprise in the circumstances referred to in paragraph 1 after the expiry of the time limits provided in its national laws and, in any case, after five years from the end of the year in which the income which would be subject to such change would, but for the conditions referred to in paragraph 1, have accrued to that enterprise.
>
> ...
>
> [Emphasis added.]

The TCC held that the Part XIII assessment was not too late. Article 9(3) did not apply to the deemed dividend because it was not an adjustment to the Luxembourg parent's income or an assessment of tax against the Luxembourg parent. In addition, Article 9(1) did not apply to the deemed dividend, and therefore Article 9(3) did not apply to the deemed dividend, because it would not have been paid if arm's length terms had applied between the parties. The Court noted that the result was consistent with the treaty's purpose because no double tax resulted, as no material amount of tax was paid in Luxembourg.

The TCC's decision in *McKesson* has been appealed.

Because transfer pricing cases like *McKesson* effectively involve the resolution of a fact-specific valuation issue, it is sometimes difficult to distill general principles from them, apart from observing that it is very difficult for a court to determine an arm's length price in a unique situation where no comparables are readily available. Nevertheless, the TCC's decision in *McKesson* contains many practical lessons for taxpayers who are engaged in non-arm's length transactions across borders. First, it is important to engage properly qualified transfer pricing experts. The Court in *McKesson* was critical of the TD Securities report in part because it was written by an expert in securitization, whereas the transaction at issue was a factoring transaction. Second, it is important to review drafts of the transfer pricing reports before the transactions are implemented and to question and confirm the assumptions made therein. Finally, the *McKesson* case is a reminder that parties that engage in aggressive transfer pricing planning should be prepared for a long, arduous and expensive battle with tax administrators and be prepared for an outcome that is highly uncertain. In *McKesson*, McKesson Canada sold a massive amount of receivables that had an exceptionally high historical collection rate and a short average collection period for a significant discount in order to eliminate Canadian tax. The CRA's willingness to fight over this case is not surprising.

© The Canadian Petroleum Tax Society

Devon

Devon is a case dealing with the interpretation of the successor rules. The successor rules are elective rules which allow a corporation that acquires all or substantially all of the resource properties of a vendor to claim the unused resource expenses of the vendor against production income or sale proceeds from the properties. These rules are deemed to apply as restrictive "streaming" rules upon an acquisition of control to prevent trading in resource pools.

In 1987, Parliament introduced a deeming rule in paragraph 66.7(10)(j) to clarify that a corporation that was a member of a partnership that owned a Canadian resource property could deduct successored resource expenses against income from that property after an acquisition of control of that corporation. Under paragraph 66.7(10)(j), successored resource expenditures only can be deducted against income that "may reasonably be regarded as being attributable to…" production from the relevant properties. The relevant portions of subsection 66.7(10) state:

> Where at any time after November 12, 1981
>
> (a) control of a corporation has been acquired by a person or group of persons, or…
>
> for the purposes of the provisions of the Income Tax Application Rules and this Act (other than subsections 66(12.6), (12.601), (12.602), (12.62) and (12.71)) relating to deductions in respect of drilling and exploration expenses, prospecting, exploration and development expenses, Canadian exploration and development expenses, foreign resource pool expenses, Canadian exploration expenses, Canadian development expenses and Canadian oil and gas property expenses (in this subsection referred to as "resource expenses") incurred by the corporation before that time, the following rules apply: …
>
> (j) where that time is after January 15, 1987 and at that time the corporation was a member of a partnership that owned a Canadian resource property or a foreign resource property at that time
>
>> (i) for the purpose of paragraph (c), the corporation shall be deemed to have owned immediately before that time that portion of the property owned by the partnership at that time that is equal to its percentage share of the total of amounts that would be paid to all members of the partnership if it were wound up at that time, and
>>
>> (ii) for the purposes of clause 29(25)(d)(i)(B) of the Income Tax Application Rules, clauses (1)(b)(i)(C) and (2)(b)(i)(B), subparagraph (2.3)(b)(i) and clauses (3)(b)(i)(C), (4)(b)(i)(B) and (5)(b)(i)(B) for a taxation year ending after that time, the lesser of
>>
>>> (A) its share of the part of the income of the partnership for the fiscal period of the partnership ending in the year that may reasonably be regarded as being attributable to the production from the property, and
>>>
>>> (B) an amount that would be determined under clause (A) for the year if its share of the income of the partnership for the fiscal period of the partnership

© The Canadian Petroleum Tax Society

> ending in the year were determined on the basis of the percentage share referred to in subparagraph (i),
>
> shall be deemed to be income of the corporation for the year that may reasonably be attributable to production from the property.
>
> [Emphasis added.]

In *Devon*, Anderson Exploration Ltd. ("**Anderson Exploration**") was acquired by Devon Acquisition Corporation. At the time of the acquisition of control, Anderson Exploration owned all of the shares of Home Oil Company of Canada ("**Home Oil**"), Home Oil was a direct member of Anderson Exploration Partnership ("**Anderson Partnership**"), and Anderson Partnership held certain resource properties. After the acquisition of control, Anderson Partnership transferred its resource properties to a subsidiary partnership, Devon Canada Partnership.

Home Oil eventually was amalgamated and continued as the appellant. The Minister reassessed the appellant to deny its claim for successor deductions in respect of the resource properties that had been transferred to Devon Canada Partnership. The Minister took the position that paragraph 66.7(10)(j) ceased to apply after the properties were transferred to a subsidiary partnership.

The relevant issue was brought before the TCC on a motion to determine a question of law. The TCC reframed the issue before it as being "whether a corporation can continue to deduct "successored" resource expenses against income from a resource property that has been transferred from a partnership of which it is a direct member to a subsidiary partnership following an acquisition of control."[38] The TCC decided this question affirmatively.

Hogan J. stated that Home Oil was deemed by subparagraph 66.7(10)(j)(i) to have acquired its share of the properties owned by Anderson Partnership immediately before the acquisition of control, and he found that there was no subsequent event to terminate this deemed ownership.

The TCC also concluded that income earned through the subsidiary partnership could "reasonably be regarded as being attributable to" production from the resource properties. The reasons for this were as follows. First, Hogan J. noted that, at common law, partners own the property of a partnership. Second, he observed that subsection 96(1) preserves the source of partnership income in the partners' hands. He also noted that, in *Fredette v. R.*,[39] the TCC held in a tiered partnership context that the source and location of partnership income was preserved until that income was allocated to corporate or individual partners. Moreover, he noted that subsection 102(2) provides further support for this conclusion, by specifying that "[i]n this subdivision, a reference to a person or a taxpayer who is a member of a particular partnership shall include a reference to another partnership that is a member of the particular partnership." Finally, Hogan J. emphasized that, ultimately, Home Oil paid tax on income earned from the resource properties transferred to the subsidiary partnership. (As an aside, in interpreting the phrase "reasonably be regarded as being attributable to", the Court referred to case law and CRA administrative policy interpreting similar phrases in subsection 55(2) and subsection 152(4.3).)

In addition, Hogan J. considered the policy reason for introducing paragraph 66.7(10)(j), which was to ensure that successor deductions would be available to corporate partners of partnerships which held resource

© The Canadian Petroleum Tax Society

properties at the time of an acquisition of control. He concluded that denying the deduction in this circumstance would frustrate that purpose because successored resource expenses then would be stranded. Such stranding would defeat the purpose of the successor rules, as several of those rules are designed to prevent that very result.

Clearly, the TCC's conclusion reflects the correct policy result. There is no reason why resource properties held in a subsidiary partnership should be treated differently under the successor rules from resource properties held in a first-tier partnership. Accordingly, this decision is one that enhances fairness, certainty and predictability for taxpayers.

It is apparent from reading Hogan J.'s judgment that he considered the policy reasons behind paragraph 66.7(10)(j) in determining whether income earned through the subsidiary partnership could "reasonably be regarded as being attributable to" production from the resource properties. It is interesting to compare the Court's reasoning in this context to its reasoning in *D & D Livestock* (discussed below), where the Court knew that its interpretation of a similar phrase in subsection 55(2) would lead to the wrong result from a policy perspective.

D & D Livestock

The relevant facts in *D & D Livestock* can be described succinctly. As part of a corporate reorganization prior to a sale, a parent corporation ("**Parent**") paid a stock dividend ("**First Dividend**") of approximately $1.47 million. At the time that the First Dividend was paid, the so-called "safe income" of Parent was approximately $1.5 million, and consisted of approximately $976,000 of safe income of Parent and approximately $517,000 of safe income of a subsidiary corporation ("**Subsidiary**") of Parent.[40] As a result, subsection 55(2) did not apply to the First Dividend. Shortly thereafter, Parent transferred the shares of Subsidiary to a new corporation ("**Newco**").[41] After that, Newco paid a stock dividend ("**Second Dividend**") of approximately $517,000 in several parts, pursuant to paragraph 55(5)(f). The question was whether the payment of the First Dividend exhausted the safe of income of Subsidiary (and therefore Newco) such that the Second Dividend was subject to subsection 55(2).

The appellant in this case admitted that there had been a duplicate use of safe income, but argued that the Act mandated that result.

Somewhat surprisingly, the TCC allowed the appeal and held that the Second Dividend was reasonably attributable to safe income of Newco. Graham J. acknowledged that subsection 55(2) is a specific anti-avoidance rule which is designed to prevent capital gains stripping and that the appellant had engaged in capital gains stripping. Although such a conclusion might have been fatal to a taxpayer under the GAAR, the Minister did not argue that the GAAR applied. To make use of the safe income exception to subsection 55(2), a taxpayer must prove that the capital gain "could reasonably be considered to be attributable to" safe income. Graham J. held that the words of subsection 55(2) were clear in this case and that the capital gain on the Newco shares was not reasonably attributable to anything other than Newco's (or Subsidiary's) safe income.

As Graham J. clearly acknowledged in his reasons, the decision does not reflect the correct policy result. If this interpretation stands, as long as there is enough safe income somewhere in the corporate group, a taxpayer

© The Canadian Petroleum Tax Society

may be able to use the same safe income a number of times by paying dividends in the right order. However, it is quite likely that, in future cases, the Minister will argue that the GAAR applies to preclude such a result.

Swirsky

In *Swirsky*, Mr. and Mrs. Swirsky both owned shares of Torgan Construction Ltd. ("**Torgan**"), a family corporation involved in the real estate development business. Torgan became involved in a project that eventually got into serious financial trouble. Because Mr. Swirsky and the other participant in the project had provided personal guarantees on the loans for the project, and the other participant warned Mr. Swirsky that he had taken steps to protect himself from liability under those guarantees, Mr. Swirsky became very concerned about creditor-proofing. As a result, Mr. Swirsky transferred his shares of Torgan to Mrs. Swirsky in 1991, 1993 and 1995. Mrs. Swirsky borrowed funds for each purchase. Mr. Swirsky used the proceeds of sale to repay his shareholder loans to Torgan, Torgan used those funds to acquire a guaranteed investment certificate ("**GIC**"), and Torgan then assigned the GIC to the lender. The lender applied the interest from the GICs against the interest on the loans. The small amount of net interest payable on the loans was paid for by Torgan, which then charged Mr. Swirsky's shareholder loan account (though it was said that this was an error and that Mrs. Swirsky's shareholder loan account was supposed to be charged). Torgan also provided a guarantee on the loan to Mrs. Swirsky and Mrs. Swirsky was supposed to pay Torgan a small fee for doing so. However, Torgan erroneously charged Mr. Swirsky's shareholder loan account for this amount as well. Under the attribution rules in the Act, interest and carrying charges were attributed to Mr. Swirsky and he deducted them for income tax purposes.

Importantly, at the times that Mrs. Swirsky acquired the Torgan shares from Mr. Swirsky, Torgan did not have a history of paying dividends. The shareholders generally had taken money out of Torgan by way of shareholder loan or bonus. Torgan paid its first dividend - a $2.5 million capital dividend - in 1999. It also paid a $1.6 million dividend in 2003, and other dividends in 2004 and 2005.

The Minister reassessed Mr. Swirsky to disallow his losses from the deduction of interest and carrying charges on the alternative bases that: (1) Mrs. Swirsky was not entitled to deduct interest and carrying charges because the loan proceeds were not used by her for an eligible income-earning purpose, as required under paragraphs 20(1)(c) and 20(1)(e.1); (2) subsection 74.5(11), which prevents the use of the attribution rules to reduce tax, applied; and (3) the GAAR applied.

The TCC dismissed Mr. Swirsky's appeal and held that the interest expenses and carrying charges were not deductible. First, the TCC held that Mrs. Swirsky had no intention of acquiring the Torgan shares to earn dividend income. The TCC found that Torgan had no history of paying dividends when Mrs. Swirsky acquired the shares and that the shares were transferred to her for creditor-proofing reasons. In fact, Mrs. Swirsky testified that she expected to transfer the shares back to Mr. Swirsky after the financial risk passed, and she eventually did so as part of a divorce settlement. Moreover, the TCC noted that Mrs. Swirsky did not have to pay the interest or carrying charges herself, so she likely was not concerned with the income-earning potential of the shares.

In *obiter*, the TCC considered the application of subsection 74.5(11). In its discussion, the Court stated that the purpose test therein, like the avoidance transaction test in paragraph 245(3)(b), required "an objective assessment of the relative importance of the driving forces of the transaction."[42] The TCC held that subsection 74.5(11) did not apply because one of the main reasons for the transfers was not to reduce tax. The TCC

© The Canadian Petroleum Tax Society

found that the main reasons for the transfers were creditor-proofing and to pay off Mr. Swirsky's shareholder loans.

Also in *obiter*, the TCC considered the application of the GAAR and concluded that it did not apply. Interestingly, the TCC was of the view that the Minister had the onus of proving there was a tax benefit because the Minister first invoked the GAAR at the confirmation stage. The TCC also noted that there was no avoidance transaction because the transactions were carried out primarily for creditor-proofing reasons. Otherwise, the TCC observed that the transactions were similar to those in *Lipson v. Canada*, where the majority of the SCC held that the GAAR applied.[43]

The TCC's decision in *Swirsky* was appealed to the FCA. The FCA affirmed the TCC's decision and held that interest and carrying charges were not deductible. The FCA held that the TCC correctly looked at the objective and subjective manifestations of purpose to determine whether Mrs. Swirsky acquired the Torgan shares for an income-earning purpose. The Minister abandoned the subsection 74.5(11) argument at the FCA, so that argument was not considered. Dawson J.A. declined to comment on the GAAR and specifically on the TCC's comment with respect to the Minister's onus in proving a tax benefit.

This decision has caused some concern because of its potential application to standard commercial situations involving an acquisition of common shares. Tax advisors often assume that interest payable on borrowed money that is used to acquire shares automatically is deductible under paragraph 20(1)(c), pursuant to the CRA's administrative policy. In reality, the CRA's administrative policy is more nuanced:

> Where an investment does not carry a stated interest or dividend rate such as some common shares, the determination of the reasonable expectation of income at the time the investment is made is less clear. Normally, however, the CCRA considers interest costs in respect of funds borrowed to purchase common shares to be deductible on the basis that there is a reasonable expectation, at the time the shares are acquired, that the common shareholder will receive dividends. Nonetheless, each situation must be dealt with on the basis of the particular facts involved.[44]

To minimize the risk of the non-deductibility of interest in situations similar to the one in *Swirsky*, taxpayers would be well advised to ensure that: (1) some dividends are paid periodically on the shares acquired with borrowed money; (2) the corporation whose shares are being acquired has a dividend policy which contemplates the payment of dividends; and (3) the person acquiring the shares retains evidence that shows that he or she considered whether income would be earned from the investment.

Conclusion

That is a brief glimpse at some of the latest tax avoidance jurisprudence. With broad legislative concepts to interpret, relatively limited guidance from past case law, and analogies to other provisions in the Act, the judiciary has done its best. While some of these decisions can be seen as enhancing the fairness, certainty and predictability of the tax system, others seem to have the opposite effect. But the process does not end here. As new cases interpreting the existing anti-avoidance rules are decided, new anti-avoidance rules in need of interpretation are sure to follow. While there may be some deviations along the way, it is hoped that this legislative and judicial process will lead to a tax system that is more equitable and better understood by both taxpayers and government.

© The Canadian Petroleum Tax Society

1 This paper was prepared in conjunction with a presentation made at the 2014 Canadian Petroleum Tax Society Annual Conference which took place in Calgary on June 4, 2014. The information herein is current as of that date.
2 Of Felesky Flynn LLP (Calgary). The author gratefully acknowledges the assistance of Messrs. Ken Skingle and Brett Anderson in reviewing earlier drafts of this paper and the accompanying presentation materials. The author also gratefully acknowledges the research assistance of Mr. Derrick Hosanna.
3 All references to statutory provisions are to provisions of the Act, unless otherwise noted.
4 Some examples include: subsection 55(2) (capital gains stripping); subsection 66.7(10) (application of successor rules on an acquisition of control); paragraph 95(6)(b) (acquisition or disposition of shares of a foreign affiliate); section 245 (general anti-avoidance rule); and section 247 (transfer pricing rules). Each of these anti-avoidance rules will be discussed below in the context of certain cases. The Act also contains many other anti-avoidance rules, a review of which is beyond the scope of this paper.
5 2013 TCC 310 [*Pièces Automobiles Lecavalier*].
6 2013 TCC 176, aff'd 2014 FCA 103 [*Lehigh Cement*]. This is not the same as the withholding tax appeal of *Lehigh Cement* that was decided by the FCA in 2010.
7 2013 TCC 404 [*McKesson*]. This case currently is under appeal to the FCA.
8 2013 TCC 415 [*Devon*].
9 2013 TCC 318 [*D & D Livestock*].
10 2013 TCC 73, aff'd 2014 FCA 36 [*Swirsky*].
11 Where a concept, term or expression has been judicially interpreted in the context of one provision, it may be reasonable to presume that the concept, term or expression has the same meaning throughout the Act. See the discussion on the "presumption of consistent expression" in Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes*, 4th ed., (Butterworths Canada Ltd: Markham, 2002) at 162-167.
12 The legal name for this corporation was not provided in the reasons for judgment.
13 See sections 80 and 80.01 generally. See also paragraph 80(2)(g) and subparagraph 80.01(6)(a)(ii).
14 Within the meaning of subsection 245(1).
15 Within the meaning of subsection 245(3).
16 Within the meaning of subsection 245(4).
17 Dated April 20, 1995.
18 ATR-66 referred to paragraphs 85(4)(a) and 53(1)(f.1), but paragraph 85(4)(a) has been repealed. Now this would be accomplished by paragraphs 40(2)(e.1) and 53(1)(f.1).
19 ATR-66 referred to paragraph 80(3)(b), but now this would be accomplished with subsection 80.01(4).
20 As defined in subsection 248(1) by reference to the definition in subsection 89(1).
21 This assumes that the Greenleaf shares were not "taxable Canadian property", as defined in subsection 248(1).
22 See CRA document no. 2013-0514191R3, dated 2014 (released May 7, 2014); see also CRA document no. 2014-0522501E5, dated April 4, 2014.
23 Robin MacKnight, "Forgiven, Not Forgotten: Pièces Automobiles Lecavalier" (2014) vol. 14, no. 1 *Tax for the Owner-Manager*, 6.
24 As defined in subsection 95(1).
25 2005 TCC 723.
26 2011 SCC 63.
27 Subdivision i of Division B of Part I.
28 See Part XVI.
29 Paragraphs 62 to 67.
30 See, for example, Income Tax Technical News No. 36, dated July 27, 2007; CRA document no. 2009-0347271R3, dated 2010; CRA document no. 2010-0375111R3, dated 2011; CRA document no. 2011-0400531R3, dated 2011; CRA document no. 2012-0452291R3, dated 2012.
31 *Univar Canada Ltd. v. R.*, *supra* note 25.
32 The amount of the deemed dividend was equal to the "excessive" discount on the sale of the receivables by McKesson Canada to its Luxembourg parent. See subsection 15(1) and subsection 214(3).
33 Paragraph 202.
34 2012 SCC 52 [*GlaxoSmithKline*].
35 *GlaxoSmithKline* involved the interpretation of former subsection 69(2), which included a "reasonable in the circumstances" test rather than an "arm's length" test.
36 The *primary* transfer pricing adjustment was made within five years of the end of the relevant taxation year.

© The Canadian Petroleum Tax Society

37 *Convention Between The Government of Canada and The Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital*, September 10, 1999, as amended by protocols ratified to date.

38 At paragraph 23.

39 [2001] 3 C.T.C. 2468 (T.C.C.).

40 In section 55, safe income is income earned or realized by *any* corporation and, therefore, is computed on a "look-through" basis. The safe income of a parent corporation includes the safe income of its subsidiary corporation, but the safe income of a subsidiary corporation does not include the safe income of its parent corporation. See the discussion of the relevant case law and CRA commentary in Rick McLean, *Understanding Section 55 and Butterfly Reorganizations*, 3rd ed., (CCH Canadian Limited: Toronto, 2010) at 67-69.

41 Because safe income is computed on a "look-through" basis, after this transaction, Newco would have had safe income equal to Subsidiary's safe income.

42 The Court took this requirement from the SCC's decision in *Canada Trustco v. Canada*, 2005 SCC 54 at paragraph 28.

43 2009 SCC 1.

44 *Interpretation Bulletin* IT-533, dated October 31, 2003, at paragraph 31.

The Canadian Petroleum Tax Journal is provided with the editorial support of the Thomson Reuters Taxnet Pro Online Tax Team.

© The Canadian Petroleum Tax Society