“Whoever hopes a faultless tax to see, hopes what ne’er was, is not and ne’er shall be.”

— Alexander Pope

Introduction

There are judicial tools available, including a number of common law doctrines, for use by the courts in Canada in dealing with abusive tax avoidance; however, there is no route currently recognized in our courts for setting aside tax avoidance transactions on the ground that they are lacking in economic substance.¹ This stands in contrast with the position in the U.S.,² where its longstanding

¹ James Morgan, “Cross-Border Regulation of Tax Shelters: The Implied Economic Substance Doctrine”, Tax Notes International 387-395 (Oct. 22, 2007), 395 (arguing that the development by national judiciaries of a body of precedent based on economic substance would provide a standard for multinational enterprises re tax avoidance).

² David P. Hariton, “When and How Should the Economic Substance Doctrine be Applied?”, 60 Tax Law Review 29-56 (2006), 33-34 (the judicial economic substance doctrine is used to guard against the success of tax avoidance transactions engineered to result in tax benefits, where there is no risk of loss); Yoram Kenan, “The Many Faces of the Economic Substance’s Two-Prong Test: Time For Reconciliation?”, 1 NYU Journal of Law and Business 371-456 (2005), 387 (the economic substance doctrine, the substance over form or step transaction doctrines and statutory anti-abuse rules are the three major means that the IRS uses for disallowing tax benefits arising from tax-motivated transactions); Joseph Bankman, “The Tax Shelter Problem”, 57 National
common law economic substance doctrine has recently been codified. Also, as I show in this book, Canada is now out-of-step with Australia, New Zealand, South Africa and the European Court of Justice, regarding the role economic substance plays in tax avoidance cases.

We require legislative amendments in Canada, to enable us to emulate the U.S. treatment of economic substance, and to bring us abreast with its treatment in Australia, New Zealand, South Africa, and by the European Court of Justice. This is because the Supreme Court has severely restricted the ability of the lower courts to rely upon findings as to economic substance in tax avoidance cases, apart from for the limited purpose of determining whether transactions are an abuse or misuse of the provisions of the Income Tax Act.

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3 Tax Journal 925 (2004), 928 (the economic substance doctrine is a “blunt instrument”, that works best in the most egregious cases, which is not applied in the face of clearly expressed legislative intent); Jeff Rector, “A Review of the Economic Substance Doctrine”, vol. 10, no. 1 Stanford Journal of Law, Business & Finance, 173-190 (2004), 174 (the economic substance doctrine is “the Government’s trump card” because where the legal form chosen technically complies with all of the statutory requirements for obtaining a deduction, tax benefits are denied when the transactions lack economic substance).

4 H.R. 4872, 111th Cong., § 1409. Also see my discussion of the US position re economic substance in chapter VI.

5 The position of economic substance vis-a-vis the GAARs in Australia, New Zealand and South Africa is examined in chapter VII. Also note that the illustrative draft GAAR that is presently being considered in the U.K. includes economic substance as an objective factor to be used in detecting abusive tax avoidance – see my examination of this point in chapter VII.

6 David Bishop Debenham, “From the Revenue Rule to the Rule of the ‘Revenue’: A Tale of Two Davids and Two Goliaths”, (2008) vol. 56, no. 1 CTJ 1-66, 13 (commenting that the Supreme Court of Canada has taken a restrictive view of the common law doctrines that attempt to eliminate aggressive tax avoidance schemes, whereas the U.S. Supreme Court and lower courts have been receptive to common law doctrines designed to curb such schemes); also see: “Discussion Paper on Tax Avoidance”, (Law Administration, South African Revenue Service, November 2005). 37 (stating in so far as “robust judicial doctrines to counter abusive tax avoidance schemes” have been developed in the U.S. courts, but not in Canada “generally reflect(s) a willingness of the American courts to grapple with business and commercial realities in the tax arena.”).
Economic Substance and Tax Avoidance: An International Perspective
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... in the last stage of analysis under GAAR in subsection 245(4) of the Act. In the Supreme Court’s words, in its initial decision concerning the application of GAAR, a “lack of substance … [has] no meaning in isolation from the proper interpretation of specific provisions of the Income Tax Act.”

The Supreme Court’s position has been criticized by Canadian academics as an unfortunate and wrong limitation. There is no justification for restricting examinations of economic substance to those circumstances where specific provisions of the Income Tax Act are being interpreted. Indeed, there are few provisions in the Income Tax Act for which an economic substance inquiry is even germane. Moreover, determining whether transactions have economic

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6 RSC 1985, c. 1 (5th Supp.) as amended (hereinafter referred to as “the Act”).
7 Canada Trustco Mortgage Co. v. R., [2005] 2 S.C.R. 601 (S.C.C.) at paras. 59 and 66; see also: Lipson v. R., [2009] 1 C.T.C. 314 (S.C.C.) at para. 38, per LeBel J. (“Motivation, purpose and economic substance are relevant under s. 245(4) only to the extent that they establish whether the transaction frustrates the purpose of the relevant provisions (Canada Trustco, at paras. 57-60”).
8 Benjamin Alarie, Sanjana Bhatia and David G. Duff, “Symposium on Tax Avoidance After Canada Trustco and Mathew: Summary of Proceedings” (2005) vol. 53, no. 4 CTJ 1010, per Professor Jinyan Li, 1016-18, 1024 (arguing that the Supreme Court’s approach to economic substance under GAAR is too narrow. “Transactions lacking economic substance should be presumed to frustrate the legislative purpose of the Act, unless the transactions are clearly supported by the text, context, and purpose of specific provisions or the Act read as a whole”); Brian J. Arnold, “Confusion Worse Confounded – The Supreme Court’s GAAR Decisions”, (2006) vol. 54, no. 1 CTJ 187-209, 192, 208-209 (according to the Supreme Court of Canada, reference to the economic substance of transactions is warranted under ss. 245(4) of the Income Tax Act only if the relevant statutory provisions justify it. “The court has rendered the GAAR virtually meaningless by restricting the significance of economic substance,” and “Without consideration of the economic substance of a transaction the GAAR will be ineffective”); Jinyan Li, “Economic Substance: Legitimate Tax Minimization vs. Abusive Tax Avoidance”, (2006) vol. 54, no. 1 C.T.J. 23-56, 27 (arguing that “consideration of economic substance is called for by Parliament through the enactment of the GAAR”; this is “consistent with the purposive approach to statutory interpretation”; it is “justified on theoretical grounds”; and, evaluation of economic substance is “the best method for balancing conflicting policy concerns in Canadian income tax law”).
9 Arnold, supra no. 8 at 192 (noting that very few provisions in the Income Tax Act refer to economic substance); also see Brian A. Felesky and Sandra E. Jack, “Is There Substance to ‘Substance Over Form’ in Canada?”, (1992)
substance involves a factual inquiry, which is not itself an aspect of statutory interpretation. Although Halpern and many others have argued that consideration of economic substance independently from the particular language of the taxing statute “risks venturing onto policy-making terrain usually reserved for the legislature,” I do not find this argument convincing, for reasons I explain in chapter V, in my review and evaluation of the Supreme Court of Canada’s position regarding economic realities and substance. Rather, the nexus of economic substance with statutory interpretation is that a proper question for courts to be asking in tax avoidance cases is whether Parliament intended, when enacting the relevant tax legislation, that transactions without economic substance should give rise to tax benefits. Unfortunately, however, the position of the

Conference Report (Toronto: Canadian Tax Foundation, 1993), 50:1-50:63, 50:45 (arguing that “The fact that only certain provisions of the Act specifically contemplate that the tax consequences of a transaction may not be consistent with the legal effect thereof is strong support for the proposition that the scheme of the Act does not provide for a general economic substance doctrine.”). Nik Diksic, “Some Reflections on the Roles of Legal and Economic Substance in Tax Law”, 2010 Conference Report (Toronto: Canadian Tax Foundation, 2011), 25:1-34 (suggesting that “the preferred share rules ... are a rare instance of prescriptive statutory provisions that are designed to effectively treat certain share investments as debt based on clearly articulated ‘economic substance’ principles.”).

Li, supra no. 8 at 34, 37, 44 (commenting that while the examination of economic substance is a factual determination which calls for the taxpayer’s transaction to be assessed “with an eye to commercial and economic realities”, “The economic substance analysis has a more natural fit with a purposive interpretation of the statute.”).

James S. Halpern, “Putting The Cart Before The Horse: Determining Economic Substance Independent of the Language of the Code”, 30 Virginia Tax Review 327-338 (2010), 328-329 (also arguing with regard to the Federal Circuit’s statement in Coltec Industries Inc. v. United States that “[T]he economic substance doctrine is merely a judicial tool for effectuating the Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance.”, “I agree but caution that difficulties in framing the relevant transaction and identifying the pertinent Congressional purposes may make the search for economic substance more problematic than it would at first appear.”)

See my discussion of the “self-defeating” theory of statutory interpretation in chapter VI.
Supreme Court as to the minor ancillary role of economic substance in tax avoidance cases precludes this inquiry.

My contention is that the general anti-avoidance rule ("GAAR") in section 245 of the Income Tax Act\textsuperscript{13} should be amended, in order to bring clarity and consistency to this difficult area, to require that the economic substance of transactions must be considered as a relevant factual element in determining, for the purposes of GAAR, whether a transaction is an “avoidance transaction”, and also in deciding whether the transaction results in a misuse of the relevant taxing provisions or an abuse of the Act when read as a whole.\textsuperscript{14}

I also contend that GAAR should be amended to provide that transactions which are primarily entered into in order to secure tax benefits, and which are found not to have substantial\textsuperscript{15} economic

\textsuperscript{13} RSC 1985, c. 1 (5th Supp.) as amended (hereinafter referred to as “the Act”)

\textsuperscript{14} Judith Freedman, “Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited”, vol. 6 British Tax Review 717-736 (2010), 728 (suggesting that a general anti-avoidance principle with a direction from the legislature that economic substance is a factor in the application of the principle would be acceptable as “a broad principle intended to underpin the entire tax system”, and operative as “part of the architecture of the legislation”); see also: Brian J. Arnold, “The Canadian General Anti-Avance Rule”, vol. 6 British Tax Review 541-556 (1995), 550 (warning, however, against the “real danger” that the interpretation of subsection 245(4) “will degenerate into an unprincipled, conclusory approach based on judges’ views of the substance or economic reality of transactions.”).

\textsuperscript{15} Regarding the proposed requirement for “substantial economic consequences” in relation to the expected tax benefits see: Jasper L. Cummings, Jr., “Enforcement Responses to Intentional Tax Reduction, Including the Economic Substance Doctrine”, The Supreme Court’s Federal Tax Jurisprudence, American Bar Association Section of Taxation, 145-241 (2010), 232 (suggesting that “by using the term ‘substantial’ [in the codified economic substance doctrine] Congress intended to send a message that it will not be enough for taxpayers to prove a reasonable (much less a remote) possibility of some economic profit.”); Bret Wells, “Economic Substance Doctrine: How Codification Changes Decided Cases”, vol. 10, no. 6 Florida Tax Review 416-457 (2010), 435 (commenting that “the bifurcation authority set forth in section 7701(o)(5)(D) [of the codified economic substance doctrine] now calls into question the ability of a taxpayer to bootstrap a tax motivated step into an overall transaction unless the tax motivated step has a ‘substantial’ economic consequence when judged on a stand-alone basis.”); Tony Swiderski and Alexey Manasuev, “The New
consequences for the taxpayer in relation to their expected tax benefits,\textsuperscript{16} shall be presumed not to give rise to any tax benefits.

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\textsuperscript{16} US Statutory Economic Substance Doctrine: They Forgot the Important Parts — Has Everything or Nothing Changed?”, 2010 Conference Report (Toronto: Canadian Tax Foundation, 2011), 18:1-31 (predicting that the codified economic substance doctrine in the U.S. “will tend to have greater application to a transaction that results in disproportionate tax benefits, such as tax attribute duplication, the allocation of income to a tax-indifferent party, the creation of a tax loss that is not supported by a corresponding economic loss, the affirmative use of technical tax rules to yield a result that was clearly not intended and the like.”); Marie Saparie, “Codified Economic Substance Doctrine Still an Uncertain Area”, 129 Tax Notes 30-31 (Oct 4, 2010), 31 (referring to a tax practitioner suggesting that it is unclear what level of profit will be considered “substantial” compared with tax savings, but if pretax profit potential is less than 10 percent of tax savings there is a significant risk it will be considered insubstantial whereas “if the pretax profit potential is more than half the tax savings, … that’s pretty clearly substantial compared to the tax benefit”, and it’s “anybody’s guess” where the courts and the IRS are going to draw the line between 10 percent and 50 percent). Rachel Anne Tooma, “Legislating Against Tax Avoidance”, (Amsterdam: IBFD, 2008), 48 (suggesting that the economic substance doctrine has applied in the U.S. to disallow tax benefits “where there is a gross departure from sensible economic results and the fundamental tax principles underlying the Code”); Noël B. Cunningham and James R. Repetti, “Textualism and Tax Shelters”, 24 Virginia Tax Review 1-63 (2004), 23 (noting that under the economic substance doctrine before its codification “the courts will deny tax benefits if the purported pre-tax economic profit is insubstantial in relation to the value of the expected benefits from the transaction”); David A. Weisbach, “Ten Truths About Tax Shelters”, vol. 55 Tax Law Review 215-254 (2001-2002), 228 (noting that some U.S. court cases have treated “transactions that yield a profit only minimally above zero … transactions that no sane person would enter into absent taxes, as having adequate tax potential.”); Daniel N. Shavaro, “Economic Substance, Corporate Tax Shelters and the Compaq Case”, 88 Tax Notes 221-244 (July 10, 2000), 243 (noting IRS Notice 98-5 requires the expected economic profit from a deal to be more than “insubstantial” compared to the foreign tax credits generated), Calvin H. Johnson, “I.R. _____, The Anti-skunk Works Corporate Tax Shelter Act of 1999”, 84 Tax Notes 443-461 (July 19, 1999), 447 (“Having tax benefits greater than the entire cost of the transaction is the reductio ad absurdum for a transaction. Transactions with a cost less than the tax benefit have no economic meaning except for tax and no economic constraints except by the courts ripping away the tax benefits. Tax is not supposed to be a profit center. … The closer that the cost is to the value of tax benefits and the farther the deducted amount is from true losses … the more questionable the transaction becomes.”).
That is to say, although the transactions have ostensibly given rise to a “tax benefit”, it will be denied unless the taxpayer can show that the benefit was legislatively intended.¹⁷

These proposals are made for a number of reasons: (1) they represent a simple and modest incremental change to the existing GAAR provisions, rather than a radical overhaul – they can thus be easily implemented and should be palatable as legislative measures;¹⁸ (2) they rely upon a conceptual foundation with which the courts and taxpayers are already familiar – the courts are very experienced with respect to the meaning of “substantial”;¹⁹ and, as I

¹⁷ The statutory presumption is rebuttable – see the discussion of this point that follows. Also see: Taxation of Private Corporations and Their Shareholders, 4th ed. (Toronto: Canadian Tax Foundation, 2010), Paul Bleivas and John Hutson (eds.), c. 16. V. GAAR, Canada’s Answer to Tax Avoidance. B. Analysis of Section 245, 7. Misuse or Abuse, h. Selected Supreme Court of Canada Cases (commenting that “One question that continues to be troublesome is the statement in Canada Trustco that the burden is on the Minister to establish the existence of ‘abusive tax avoidance’”).

¹⁸ John Prebble, “The US GAAR”, Victoria University, Wellington NZ Tax-ProfBlog, May 25, 2010 (suggesting that “[O]nce the major philosophical decision has been taken and a GAAR is in place, most legislatures become willing to amend and improve it as litigation reveals loopholes or shortcomings.”)

¹⁹ The Tax Court of Canada General Procedure Rules contemplate determinations of questions of law, fact or mixed law and fact under Rule 58, and special cases under Rule 50, where the result would be a “substantial saving of costs” and Practice Note 18 speaks of “substantial indemnity costs” in the context of settlement offers. The Supreme Court of Canada also often uses the term “substantial” in a tax context, e.g.: Lipson v. R., (sub nom. Lipson v. Canada) [2009] 1 S.C.R. 3 (S.C.C.) at para. 70 (“substantial block of stock”); Air Canada v. British Columbia, [1989] 1 S.C.R. 1161 (S.C.C.) at para. 96 (“substantial agreement”); Symes v R., (sub nom. Symes v. Canada) [1993] 4 S.C.R. 695 (S.C.C.) at para. 21 (“substantial objective”); Stobart Investments Ltd. v. R., [1984] 1 S.C.R. 536 (S.C.C.) at para. 3 (“substantial losses”); Simpson-Sears Ltd. v. New Brunswick (Provincial Secretary), [1978] 2 S.C.R. 869 (S.C.C.) at para. 30 (“substantial number”); Vancouver Society of Immigrant & Visible Minority Women v. Minister of National Revenue, [1999] 1 S.C.R. 10 (S.C.C.) at para. 200 (“substantial effect”). There are also many instances where determinations as to the meaning of “substantial” have been made for Income Tax Act purposes; and, the courts have held that the term does not need to be expressed quantitatively or as a percentage – see the

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show in this book, the courts are well-acquainted with finding, and often already make decisions by reference to, the perceived “economic realities” of transactions;\(^\text{20}\) (3) they will send a signal to taxpayers that the government is serious about its efforts to curb abusive tax avoidance – this possibly having some beneficial deterrent tax effects;\(^\text{21}\) (4) they leave considerable flexibility for the courts in judging whether transactions should be respected for tax purposes – this being imperfect, but preferable to the further proliferation of complex and difficult to apply technical tax rules, which are mostly designed after-the-fact, in an attempt to combat the abusive tax avoidance which has emerged;\(^\text{22}\) (5) they should encourage the

\(^\text{20}\) See Appendix A for examples of tax cases where the courts have made findings re economic realities.

\(^\text{21}\) Benjamin Alarie, “Price Discrimination in Income Taxation: Defending ‘Half-Hearted Anti-Avoidance’”, pp. 1-34, available at http://ssrn.com/abstract=1796284 (Mar. 26, 2001), 12 (suggesting that the “main point” of a general anti-avoidance rule is to “put taxpayers on notice in a formal way that the benefits they may claim based on literal adherence to the text of tax legislation and from respect for the formal legal substance of transactions may be elusive.”); also see: Judith Freedman, “Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle”, no. 4 British Tax Review 332-357 (2004), 333 (arguing in favour of a legislative anti-avoidance principle that “It is not the content of the provision which matters so much as the signposting that will be provided by it.”).

\(^\text{22}\) Weisbach, supra no. 15 at 229, 247 (arguing that “significantly increasing the strength of antitax avoidance doctrines” is a better approach than “making repeated amendments to complicated rules”, as a rules-based system tends to be very complex whereas standards can be less complex); Craig Elliffe and Jess Cameron, “The Test for Tax Avoidance in New Zealand: A Judicial Sea Change”, New Zealand Business Law Quarterly 440-460 (December 2010), 445 (explaining that under New Zealand’s GAAR “The court will have no hesitation (and in fact, will find it necessary) to look through the legal form of the arrangements to the economic substance of the taxpayer’s arrangements. There is more and more emphasis by the court being placed on this factor.”), Craig Elliffe and Mark Keating, “Tax Avoidance – Still Waiting for Godot?”, 23 NZULR 308-392 (June 2009), 309 (noting that under New Zealand’s GAAR the courts have “continued development of the concept of commercial reality and economic burden, clearly articulating that in order to sustain deductions or claims for input tax, the taxpayer must evidence the payments were made in a commercially and economically realistic way.”); Diksic, supra no. 9 at 25:1-34 (suggesting that “a qualified economic substance analysis” may
cours in Canada to disallow claims by taxpayers for tax benefits in circumstances where the taxpayers have not experienced any economic losses—this being the desirable result from both a fiscal and a tax policy vantage point, i.e. they should assist in stemming losses from tax revenues, which are badly needed by government, and also help to counter the other ill-effects of abusive tax avoidance; 23 (6) they will bring the tax anti-avoidance law in Canada within reasonable proximity of the tax anti-avoidance measures that are already in place in a number of other jurisdictions that are similar to Canada, including Australia, Hong Kong, Ireland, South Africa and the United States; 24 and (7) they will elevate GAAR to the position it was intended to occupy according to the explanatory Technical Notes from the Department of Finance accompanying the draft GAAR legislation, i.e. the provisions of the Income Tax Act “are intended to apply to transactions with real economic substance.” 25

It is not envisaged that making these amendments will dispense with the need to resort, on an ongoing basis, to the range of other anti-avoidance measures that are commonly used to combat abusive tax avoidance, including the enactment of specific anti-avoidance rules and the passage of retroactive legislation. 26 Indeed,

23 See my discussion of the effects of unchecked abusive tax avoidance in chapter II.
24 See my examinations of the legislative anti-avoidance regimes in other jurisdictions in chapters VI and VII.
25 Canada, Department of Finance, Explanatory Notes to Legislation Relating to Income Tax (Ottawa: Department of Finance, June 1988), clause 186 “Subsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the act to avoid tax.”; see also: David G. Duff, “The Supreme Court of Canada and the General Anti-Avoidance Rule”, Tax Avoidance in Canada After Canada Trustco and Mathew, (Irwin Law: Toronto, 2007), c. 1, p. 36 (arguing that it follows from the above statement in the Explanatory Notes that “transactions that lack economic substance might reasonably be considered to result in an abuse having regard to the provisions of the ITA read as a whole.”)
these proposed amendments to the GAAR will only have an impact on the most egregious tax avoidance transactions, where tax benefits are sought to be manufactured out of “thin air”, leaving the balance of the tax avoidance field to be dealt with as it is being currently. However, legislating an economic substance component into GAAR should improve its effectiveness.

This suggestion that GAAR should be amended to expressly incorporate an economic substance component is not a novel one.

27 Developed a perfect solution to tax avoidance and none ever will.”); also see: GAO-11-493, “Abusive Tax Avoidance Transactions”, 1-55 (May 2011). 27 (“Because [abusive tax avoidance transactions] have been a long-standing, ever-changing, and often a hidden problem ... no set of actions taken by the IRS would completely eliminate the problem.”); Tim Edgar, “Building a Better GAAR”, vol. 27 Virginia Tax Review 833-905 (2008), 833-834, 871-872 (arguing the under-inclusiveness of GAAR in Canada can best be overcome through the use of a primary business purpose test which is tailored to apply differently in the identification of tax attribute creation and tax attribute trading transactions, as compared to tax-driven transactional substitutions which “should be addressed by the legislative and executive branches of government in discharging their policy making function” on account of concerns about “institutional competence” in the latter case). Tim Edgar, “Financial Instruments and the Tax Avoidance Lottery: A View from North America”, vol. 6 New Zealand Journal of Taxation Law and Policy 63-102 (2000), 92 (suggesting that in the case of “synthetic” financial instruments that detailed legislative response is preferable to “reliance on broadly drawn purpose-based rules”); Johnson, supra no. 15 at 444 (“No single line of defense is sufficient. If a platoon wants to hold the perimeter against attack by overwhelming numbers, it needs to set up more than a single strand of barbed wire; it needs layer upon layer of defense. So too, defense of the corporate tax base and the self-reporting tax system requires a number of layers of defense.”)

The origin of the expression “thin air” is attributed to Shakespeare in The Tempest (1610).

28 See the Table of GAAR Cases in Appendix B, showing that in those cases where the Tax Court of Canada has decided to date that the GAAR does not apply, the proposed amendments only impact on the type of scenarios dealt with in the case studies included in chapter IX of this paper. They will, of course, also impact on future scenarios.

29 Graeme Cooper, “The Design and Structure of General Anti-Avoidance Regimes”, Bulletin for International Taxation 26-32 (January 2009), 31 (“A solution does not need to remove 100% of the problems; 75% is still a worthy achievement.”)

30 See, for example, Judith Freedman, “Converging Tracks? Recent Developments in Canadian and U.K. Approaches to Tax Avoidance”, (2005) vol. 53,