Copthorne – What's that smell?

By: Michael Goldberg

Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

____

A lot has been written about the SCC decision in Copthorne[1] last month. It appears that most writers were not surprised about the result in Copthorne (the taxpayer lost again), were impressed with Justice Rothstein's written reasons on behalf of a unanimous Court (9-0) and ultimately were disappointed that the SCC appears to have added little to the jurisprudence – at least by way of guidance to taxpayers, their advisors and the Minister on when GAAR should be applicable.

Yes, the SCC reaffirmed that the general GAAR guidelines set-out in Canada Trustco[2] are to be followed by courts in making GAAR determinations.[3] Yes, the SCC reaffirmed that the GAAR is to be a provision of last resort.[4] Yes, the SCC reaffirmed the principles in the Duke[5] continue to permit taxpayers to engage in tax planning.[6] And yes, the SCC admonished lower courts against seeking "overriding policies" in the Act where none exist and to not apply their olfactory senses when applying GAAR.[7]

On the other hand, the guidelines set-out in Canada Trustco continue to leave lots of room for courts to make judgement calls in respect of what constitutes an "abuse". In this regard, the SCC reaffirmed its prior comments in Lipson[8] and continued to distance itself from its comments in Canada Trustco that although "Parliament must ... be taken to seek consistency, predictability and fairness in tax law" by finding that the GAAR is a provision that by its very nature creates "uncertainty" for taxpayers.[9] To this writer anyway, this seems to leave the question of when an abuse will exist in any situation open to considerable debate and, on a practical basis, leaves tax court judges to try and cover the smell with as sound reasoning as possible.

Before delving into, what can be learned from the Copthorne decision, I'll provide a very brief reminder of what was at stake in the decision.

Copthorne in a Nutshell

In Copthorne the taxpayer was undertaking a strategy to consolidate its corporate group to allow a profitable corporation to use capital losses of another corporation in the group through an amalgamation and recognized that the amalgamation would wipe out a valuable tax pool, nearly $70 million of paid-up capital of a subsidiary corporation, if the amalgamation was done without planning (using a vertical amalgamation) but that the tax pool could be preserved with a bit of planning (using a horizontal amalgamation). A few years later the taxpayer's advisors found a use for the preserved paid-up capital – which they hoped to use to strip an extra $70 million out of Canada without any taxes.

The removal of $70 million from the CRA's coffers tax free is a lot of money and the Minister was not amused. As a result, the Minister assessed the taxpayer not only seeking to collect withholdings on a deemed dividend in respect of the removal of the $70 million from the taxpayer, but with the intention of applying penalties as well. GAAR served as the sole basis of the Minister's complaint at all levels of trial and the Minister was successful (for differing reasons) at all levels of the courts – though the application of penalties against the taxpayer was vacated.

The taxpayer's counsel made many worthy arguments – not the least of which was why would a taxpayer plan its affairs in a way that would waste a valuable tax pool when with a bit of planning the pool could be preserved?

The SCC's response was that GAAR was properly applied in the circumstances of Copthorne. In particular, using the Canada Trustco GAAR guidelines to analyze the provisions in the Act dealing with paid-up capital preservation and the particular text in the wording of subsection 87(3) (which

apparently contains a code on PUC preservation transactions in the parenthetical comments found in that provision) the GAAR was properly applied to deny Copthorne the benefit of its otherwise properly preserved PUC.

Are All PUC Preservations Transactions Caught by GAAR?

Interestingly, it appears that not all transactions that might result in PUC preservation will be abusive. In fact, it does not appear that the transactions involving the preservation of the PUC were what the SCC found to be abusive; rather it was the taxpayer's use of the PUC that gave offence. In particular, the SCC stated that:

[126] It is true that the text of s. 87(3) recognizes two options, the horizontal and vertical forms of amalgamations. It is also true that the text does not expressly preclude a taxpayer from selecting one or the other option. However, I have concluded that the object, spirit and purpose of s. 87(3) is to preclude the preservation of PUC, upon amalgamation, where such preservation would allow a shareholder, on a redemption of shares by the amalgamated corporation, to be paid amounts without liability for tax in excess of the investment of tax-paid funds.

In this regard, the SCC noted that the benefit of PUC will not be lost by a purchaser of shares if there is no avoidance transaction as will be the case in many arm's length sale situations.

Although not expressly dealt with by the SCC, it might have been instructive to consider what would have happened if instead of the taxpayer removing the PUC all at once,[10] the PUC had been slowly removed from Canada over-time. Would the transaction still have been abusive?

In this regard, the SCC's comments on when an "avoidance transaction" exists and, in particular, its comments on when a "series of transactions" will be found to exist will be of great interest to taxpayers and their advisors. To that end, the SCC confirmed that the concept of series is an extremely broad one - though it is not endlessly broad.[11] Based on the SCC's comments in Copthorne a strong argument cold be made that the return of the preserved PUC would have attracted GAAR no matter how much time passed between the transactions, though as noted by the SCC it may be possible to imagine other situations that would not attract GAAR, such as situations where intervening events caused an end to the original series.[12]

Of Parenthetical Statutory Legislation

It appears that Copthorne has clarified that in-house PUC preservation transactions intended to allow non-arm's length parties to utilize the preserved PUC by side-stepping subsection 87(3) will likely be subject to GAAR.

Does this mean that all transactions that preserve a tax pool or reduce tax will be subject to GAAR? Does the outcome depend on a judicial search for a parenthetical remark buried in the Act – or does it depend on something else?

For example, will planning that defers tax through the use of a professional corporation attract GAAR? What about planning that doesn't just defer tax but saves it, for example, by shifting one's personal investment income to a CCPC? Does GAAR apply to purification planning that preserves capital gains exemption treatment?

Clearly each of these planning techniques will result in tax benefits and, based on the broad meaning of series adopted by the SCC, it will be difficult to argue that such planning does not constitute some type of avoidance transaction or transactions. As a result, in all cases, tax advisors will be left scratching their heads, fussing over the uncertain prospect of whether such planning is abusive. In paragraph 123 the SCC suggested that:

“This uncertainty underlines the obligation of the Minister who wishes to overcome the countervailing obligations of consistency and predictability to demonstrate clearly the abuse he alleges.”

Not entirely helpful.

If one steps back and compares the transactions I’ve noted above to Copthorne one might come to the conclusion that these and other types of “relatively benign” planning just shouldn’t be abusive.[13] It is likely that a court would reach the same conclusion and the CRA wouldn’t bother trying to challenge such planning, so no one is likely to search the Act for parenthetical remarks supporting the existence of an abuse.[14]

Notwithstanding all of the excellent analysis by the SCC, one might also conclude that there was just too much money at stake in Copthorne to let the tax planning stand.[15] As such, tax advisors are advised that before implementing transactions they should breathe deeply – through their noses.

Michael Goldberg, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide. Michael’s practice focuses on tax and estate planning for entrepreneurs and their corporations (mgoldberg@mindengross.com).

---

[1] Copthorne Holdings Ltd. v. R., 2011 SCC 63.
[2] Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54 Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54.
[3] Paragraph 33 of the decision is reproduced below:

> In Trustco this Court set out the three questions to be decided in a GAAR analysis:
> 1. Was there a tax benefit ? (para. 18);
> 2. Was the transaction giving rise to the tax benefit an avoidance transaction? (para. 21); and
> 3. Was the avoidance transaction giving rise to the tax benefit abusive? (para. 36).

Paragraph 57 is also instructive as to what it will require for the SCC to overturn a decision that is as recent as Canada Trustco.
[4] See paragraph 66.
[5] Commissioners of Inland Revenue v. Duke of Westminster, [1936] A.C. 1.
[6] See paragraph 65 (with the caveat that the planning is permitted so long at it is not abusive).
[7] See paragraph 118 (the SCC found that there is no general policy in the Act against surplus stripping).
[8] Lipson v. Canada, 2009 SCC 1, [2009] 1 S.C.R. 3.
[9] See paragraph 123.
[10] Which appears to have taken place in response to certain legislative changes.
[11] See paragraphs [46] and [47], the latter of which is reproduced below.

> [47] Although the “because of” or “in relation to” test does not require a “strong nexus”, it does require more than a “mere possibility” or a connection with “an extreme degree of remoteness” (see MIL (Investments) S.A. v. R., 2006 TCC 460, [2006] 5 C.T.C. 2552, at para. 62, aff’d 2007 FCA 236, 2007 D.T.C. 5437). Each case will be decided on its own facts. For example, the length of time between the series and the related transaction may be a relevant consideration in some cases; as would intervening events taking place between the series and the completion of the related transaction. In the end, it will be the “because of” or “in relation to” test that will determine, on a balance of probabilities, whether a related transaction was completed in contemplation of a series of transactions.

The Court also confirmed its view that the phrase “in contemplation of” as used in this definition is both a “prospective” and “retrospective” concept.
[12] As noted in paragraph 47 which was reproduced above, such determinations are fact driven and little guidance was provided to assist a future court to make such a determination.
[13] A judgement call in and of itself.
[14] But what about other less conventional but not necessarily aggressive planning techniques, such as, planning to ensure connected status for Part IV tax purposes and other bright-line tests in the Act, surplus stripping techniques, ATR-66 and other loss utilization or anti-debt parking strategies and so on?
[15] Similar admonitions against courts applying a smell test have been put forward since Canada Trustco and yet it seems that the lower court decisions in Copthorne would have been decided on this basis rather than the more principled basis that was applied by the SCC (see paragraphs 26, 27 and 31).