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In this article Vern Krishna discusses the Supreme Court of Canada's decision in Copthorne and its implication on tax professionals — accountants and lawyers -who spend long hours with their noses buried in the detail of the Income Tax Act. The underlying message of the decision is clear: step back from the technical and convoluted detail of transactions to see whether an arrangement or scheme abusively undermines the object, spirit and purpose of the tax statute.

Beware, tax pros, the hanging sword
Date: March 2012
Vern Krishna

Tax law is evolutionary. In an earlier era, courts saw tax statutes as penal enactments to be strictly and literally interpreted without benefit of policy analysis into the purpose of provisions. We have moved away from that approach, but still have some distance to go before we fully embrace purposive analysis.

The Supreme Court of Canada's decision in *Copthorne* is a shot across the bow of tax professionals—accountants and lawyers—who spend long hours with their noses buried in the detail of the *Income Tax Act*. There is a danger of not seeing the forest for the trees. The underlying message of the decision is clear: step back from the technical and convoluted detail of transactions to see whether an arrangement or scheme abusively undermines the object, spirit and purpose of the tax statute. The sword of Damocles hangs by a single horse's hair over the head of every professional rendering tax opinions.

The case involved companies controlled by Li Ka-Shing and his son, Victor Li, non-residents of Canada, who invested $97 million in a Canadian company which then used $67 million of the money to purchase shares in its subsidiary. The subsidiary lost money on its investments and the family sought to utilize the losses through more profitable investments in other companies with the family group.

Under the tax rules, if the parent and subsidiary simply amalgamated, the inter-company investment of $67 million would disappear. Instead, however, in order to preserve the invested capital, there followed a complex series of amalgamations and reorganizations, the net effect of which was to convert the relationship of the companies into affiliated corporations, rather than the parent and subsidiary companies they had been initially.

The *Income Tax Act* permits shareholders to withdraw their capital tax-free from a corporation. In a vertical amalgamation of a parent and its subsidiary corporation, the capital of the intercompany invested is cancelled because it represents the investment of the parent in the subsidiary. In *Copthorne* the total investment was only $97 million, of which $67 million was down-streamed into the subsidiary.

However, where affiliated corporations (that is, sister and brother corporations) owned by a common parent are amalgamated, their capital is aggregated and becomes the capital of the new corporate amalgamated entity. Thus, a horizontal amalgamation creates a much larger capital pool that can be withdrawn tax-free.

By using a horizontal amalgamation the non-residents sought to extract $164 million tax-free even though its cash investment was only $97 million. The minister of national revenue was not amused.

None of the transactions in the series of reorganizations technically offended the provisions of the act. In aggregate, however, they resulted in an arrangement that circumvented the underlying policy of the amalgamation rules and was "abusive" of the statute.

The Supreme Court took pains to emphasize that "abusive" does not imply moral opprobrium concerning the taxpayer's efforts to minimize its taxes. Indeed, the court has repeatedly endorsed the *Westminster* principle—a 1930s English decision—that taxpayers are entitled to select courses of action or enter into transactions that minimize their tax liability.

However, Canada also has a general anti-avoidance rule (GAAR) that superimposes a purpose test in determining the validity of transactions. Thus, GAAR statutorily blunts the *Westminster* doctrine of literal interpretation by focusing on the object, spirit and purpose of tax provisions.

Purposive analysis does not depend on whether the words of the statute are clear or ambiguous. Even where the words of the act are clear, a court can determine the rationale or purpose of the words to determine whether transactions abuse the statute. Thus, GAAR analysis requires balancing between two competing interests: the interest of the taxpayer in minimizing his or her taxes through technically legitimate means and the legislative interest in ensuring the integrity of the income tax system.

An arrangement is abusive where the transaction (or series of transactions) culminates in an outcome that defeats the purpose of the statutory provisions used to implement it. It is trite to say that GAAR creates uncertainty. Of course it does. It is only when the minister cannot rely on specific provisions that he will rely on GAAR if the transactions undermine the rationale or purpose of the statute.

The general anti-avoidance rule was enacted for the very purpose of attacking transactions that escaped the literal meaning of words in provisions, but had the overall effect of frustrating and undermining the purpose of the act read as a whole. In *Copthorne*, GAAR trumped the *Westminster* principle.

To be sure, tax law moves like a glacier—imperceptibly, but distinctly obvious when viewed in. time-lapse photography. *Copthorne* is a signpost to the future. As the late U.S. Supreme Court Justice Felix Frankfurter said:

> Legislation has an aim: it seeks to obviate some mischief, to supply an inadequacy, to effect a change in policy, to formulate a plan of government. That aim, that policy is not drawn, like nitrogen, out of the air; it is evinced in the language of the statute as read in the light of other external manifestations of purpose.

We have moved a long way from the penal philosophy of tax interpretation. As professionals giving opinions on structures, we need to assess business plans from a broad perspective of purposive analysis. To adapt Cicero: Does not *Copthorne* seem to make it sufficiently clear that there can be nothing happy for the person over whom some fear of GAAR always looms?

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