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The Difficulty with Substance Doctrine
Date: April 15, 2011
Vern Krishna

The Canadian tax system has seen seminal changes in interpretational technique in the past 94 years, as we migrated from strict and literal interpretation towards limited purposive interpretation of the *Income Tax Act*. The Supreme Court of Canada's decision in *Copthorne* (heard in January and reserved), the fourth case to be decided by the court on the general anti-avoidance rule, and likely the last for some time, is expected to outline the next generation of principles of statutory construction, at least in selected areas of tax law.

The fundamental rule of statutory construction is that a provision should be interpreted in a textual, contextual and purposive way giving, if at all possible, a coherent meaning to all sections of a related group of provisions. The meaning of an ambiguous word or phrase should derive from its context and other provisions or segments of the statute in which it appears. The rule pits textual against substantive or purposive interpretation.

The difficulty with the substance doctrine is that, despite its intuitive appeal, it does not offer any objective yardstick to measure against particular facts. If applied on an ex-post basis, the doctrine leaves commercial transactions in an uncertain state. It is an unpredictable doctrine of varying reach. In 1936, Lord Tomlin dismissed it disparagingly as the "so-called doctrine" in the *Duke of Westminster*:

> [I]t is said that in revenue cases there is a doctrine that the Court may ignore the legal position and regard what is called 'the substance of the matter'… This supposed doctrine … seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned, for the doctrine seems to involve substituting 'the incertain and crooked cord of discretion' for 'the golden and straight metwand of the law.' Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be … This so-called doctrine of 'the substance' seems to me to be nothing more than an attempt to make a man pay and notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.

In 1984, the Supreme Court of Canada in *Stubart* endorsed the principle that transactions did not require any business purpose to be valid for tax purposes and that a taxpayer could arrange his or her affairs to minimize tax. In the same case, however, the court went on to say that provisions of the *Income Tax Act* should be interpreted according to their "object and

spirit."

Four years later, Parliament entrenched the "object and spirit" test or purposive interpretation in the general anti-avoidance rule: A tax driven avoidance transaction is invalid if it is "abusive"—that is, it offends the purpose of the statutory provision employed to implement it, or if it "abuses" the *Income Tax Act* read in context as a whole.

Thus, we now need to answer several questions:

- What does the transaction or arrangement achieve?
- Does the transaction fit within the plain meaning of the relevant statutory provision(s)?
- If the provision is ambiguous, does the result fit within the purpose of the statutory provision(s)?
- If it does not fit within the purpose of the provision(s), should the taxpayer be allowed the benefit of the legal form of his or her transaction or be subjected to the general anti-avoidance rule (GAAR)?

Assume, for example, that a taxpayer requires a building for business use. There are at least three alternative ways to acquire the asset. The taxpayer can:

(1) Purchase the building outright and acquire title to it immediately, but pay for it over time through mortgage financing;

(2) Lease the building and pay rent for its use, but without acquiring title in the property; or

(3) Lease the building with an option to purchase the property for a token amount of, say, $1 when the lease expires in 999 years.

In the first case, the taxpayer clearly acquires title and owns the building. The taxpayer can write-off the capital cost of the building as capital cost allowance or tax depreciation and expense the mortgage interest.

In the second case, the taxpayer does not acquire title to the property but has a user interest in exchange for rental payments, which may or may not coincide with the amount deductible as capital cost allowance or tax depreciation. The write-off would depend upon the term of the lease, the underlying cost of financing, etc.

In the third case, the economic substance of the transaction is that the taxpayer purchases the property, but with delayed transmission of title. The commercial reality of the transaction is identical to an outright purchase of the asset in the first case. As a matter of *legal* substance, however, the taxpayer is a lessee during the tenure of the lease and acquires legal title only when the lease expires in 999 years and lie or she pays the token stun of $1 by exercising the option.

Although courts may be sensitive to the economic realities of transactions, rather than being bound to what first appears to he their legal form, the *Westminster* principle is, at least since 1988, subject to two important, but contradictory, caveats. First, where the underlying statutory provision at issue is clear and unambiguous, the court should apply its terms.

Second, absent a specific provision of the Act to the contrary or a finding that the transaction is a sham, a court should respect the taxpayer's formal legal relationships, but only if they do not abuse the underlying purpose of the provision or the Act read as a whole and in context. Thus, the Canada Revenue Agency may invoke GAAR and recharacterize transactions even though they technically comply with the strict and literal wording of the Act if the transactions are abusive tax avoidance. Hence, GAAR may trump *Westminster*.

Of course, what is "abusive" depends upon purposive or substantive interpretation of the Act. The Supreme Court is expected to clarify the interplay between GAAR and formalistic technical compliance with the Act in *Copthorne*, the fourth generation decision on GAAR. We have moved a long way from strict and literal interpretation and are now but a stone's throw away from the American approach, which has statutorily mandated the economic substance doctrine in the *Internal Revenue Code*.

The lifespan of seminal decisions is getting shorter.

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