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The latest on GAAR: Supreme Court of Canada releases decision in *Copthorne Holdings Ltd.*

On 16 December 2011, the Supreme Court of Canada (SCC) released its highly anticipated decision in the case of *Copthorne Holdings Ltd.* (2011 SCC 63). The Court dismissed the taxpayer's appeal — and in so doing confirmed that the General Anti-Avoidance Rule (GAAR) in the federal *Income Tax Act* (the Act) applied to a series of transactions that, in the Court's view, would permit shareholders to be paid amounts as a return of capital in excess of the amounts invested with tax-paid funds.

The transactions in this particular case involved an amalgamation of corporations, but the reasoning in the unanimous decision, penned by Justice Marshall Rothstein, could well have broader application, including with respect to arm's-length transactions involving the acquisition of shares of a corporation having paid-up capital (PUC) in excess of their fair market value or the subsequent use of such PUC.

There is no express disagreement with the Federal Court of Appeal (FCA) decision in *Collins & Aikman,* which declined to apply the GAAR in relation to certain transactions that also permitted cross-border PUC to be increased. However, it appears that the risks associated with such planning have increased as a result of *Copthorne.* Moreover, the Court seems to reject the proposition that the object and purpose of the various PUC adjustment rules in the Act should be confined to their technical effect in the context of determining whether there is abusive tax avoidance, referring to "the PUC scheme in the Act" (para. 92). Planning with respect to PUC will thus have to be guided more by the principle that, in general, shareholders should not be paid amounts as a return of capital in excess of the amounts invested with tax-paid funds.

The SCC also provided a degree of clarification on the scope of “series of transactions” under subsection 248(10). The Court reconfirmed its earlier statement in *Canada Trustco* that a particular transaction can be considered to have been undertaken “in contemplation of” a series if the series occurs before or after the particular transaction. Moreover, the Court noted that the particular transaction must be “related” to the series, but rejected the proposition that this test requires a “strong nexus” of connection, although more than a “mere possibility” or a connection with “an extreme degree of remoteness” must be present.

Overall, the decision mostly confirms and clarifies the hallmark decision in *The Queen v Canada Trustco Mortgage Co.* (2005 DTC 5523) and *Kaulius et al v the Queen* (2005 DTC 5538), and does not represent any major watershed in these developments. The SCC’s articulation of when and how GAAR should be applied is spoken with more clarity, although some of its comments may give rise to questions and continued uncertainty.

The SCC emphasizes the importance in tax planning of going beyond the mechanical application of particular provisions of the Act as if it were a mere instruction manual or limited book of rules.

Detailed analysis

Facts

Copthorne Holdings Ltd. (Corpthorne I) was part of a large international group controlled by a non-resident family. It was incorporated in 1981 to acquire the Harbour Castle Hotel in Toronto. One common share of Copthorne I was issued for $1 to Big City Project Corporation (Big City), a Netherlands corporation controlled by Li Ka-Shing. In 1989, Copthorne I sold the Harbour Castle Hotel and realized a significant capital gain.

VHHC Investments Inc. (the Former Canadian Parent) was a corporation owned by Li Ka-Shing’s son. It had approximately $97 million of PUC. It used $67 million to purchase shares of a subsidiary corporation, VHHC Holdings Inc. (the Former Subsidiary). The Former Subsidiary in turn used those funds to invest directly and indirectly (through VHSUB Holdings Inc. (VHSUB)) in shares of Husky Oil Limited.

By 1992, the Former Canadian Parent had substantial unrealized capital losses on its shares of the Former Subsidiary, which, together with VHSUB, also had substantial unrealized capital losses on their assets, due to a decrease in the value of Husky Oil shares. In 1993, the Former Canadian Parent sold its shares of the Former Subsidiary to Copthorne I for $1,000. This was the first step in a series of transactions to shift the unrealized capital losses to Copthorne I. The Former Subsidiary sold the shares of VHSUB to Copthorne I (which inherited the high adjusted cost based due to the stop-loss rules) and Copthorne I sold the shares of VHSUB to an arm’s-length party, thus triggering the capital loss, which was carried back to shelter the gain on the sale of the Harbour Castle Hotel.

Subsequently, it was decided to amalgamate Copthorne I and the Former Subsidiary. A vertical amalgamation would have caused the PUC of the shares of the Former Subsidiary to disappear. To preserve the PUC, the shares of the Former Subsidiary were first transferred to Big City, causing Copthorne I and the Former Subsidiary to become sister corporations. These corporations, and two other Canadian corporations, were amalgamated on 1 January 1994, forming “Copthorne II.”

Later, following the 1994 FAPI amendments, the non-residents decided to withdraw assets from Canada. The following steps were undertaken:

- A new company, L.F. Investments, was incorporated in Barbados and acquired the shares of Copthorne II, as well as the shares of the Former Canadian Parent. This was a “taxable” transaction but the resulting capital gains were treaty protected, so no tax was payable under the Act.
- As a result, L.F. Investments owned Copthorne II shares with a PUC of approximately $67 million. It also owned shares of the Former Canadian Parent with a PUC of approximately $97 million, $67 million of which had been invested in the Former Subsidiary and thus was

reflected in the PUC of the Copthorne II shares because of the earlier amalgamation.

- In January 1995, Copthorne II and the Former Canadian Parent, as well as two other Canadian corporations, were amalgamated, forming Copthorne III (hereafter Copthorne), and approximately $164 million of the PUC of the amalgamating corporations was added to a class of preferred shares (the Class D Shares). As noted by the Court (para. 14), in essence, the PUC of the Class D shares was the total of the PUC of the shares of the Former Canadian Parent and the PUC of the Former Subsidiary that was derived from the share subscriptions made by the Former Canadian Parent.

- Copthorne then immediately redeemed approximately $142 million of the Class D Shares held by L.F. Investments. No amount was withheld by Copthorne in respect of this redemption because the Class D Shares had an aggregate stated capital, and therefore an aggregate PUC, of over $164 million.

Minister's assessment and the lower courts

The Minister applied the GAAR and issued an assessment for unremitted withholding tax, penalties and interest, in respect of Copthorne III's failure to withhold and remit Part XIII tax upon the redemption of the Class D Shares. The Minister's position was that there was a "tax benefit" within the meaning of subsection 245(1) that resulted from the redemption — being the avoidance of the non-resident withholding tax that would have arisen in the absence of the PUC of the Former Subsidiary having been added to the PUC of Copthorne I — and that this tax benefit resulted from a series of transactions that included an "avoidance transaction" within the meaning of subsection 245(3) of the Act, namely the 1993 sale to Big City of the shares of the Former Subsidiary. It was the Minister's position that this resulted in an abuse of the provisions of the Act within the meaning of subsection 245(4).

In the Minister's view, in order to deny the tax benefit, it was reasonable in the circumstances to reduce the PUC of the Class D Shares by approximately $67 million — being the portion of the PUC that was attributable to the shares of the Former Subsidiary — with the result that the redemption gave rise to a deemed dividend under subsection 84(3), and non-resident withholding tax under Part XIII in the amount of almost $9 million (at 15% under the treaty with Barbados). The Minister also imposed penalties on Copthorne equal to 10% of the amount that, according to the Minister, should have been withheld and remitted.

Copthorne's appeal to the Tax Court of Canada (TCC) was dismissed, except for the imposition of the penalties. The TCC agreed with the Minister that the GAAR applied to disallow the addition of approximately $67 million of PUC to the shares of Copthorne on the first amalgamations. The FCA upheld this decision, and the taxpayer appealed to the SCC.

SCC decision

The SCC dismissed Copthorne's appeal in a decision that is largely a reaffirmation of the principles set out in its previous decisions in *Canada Trustco* and *Kaulius,* with some additional clarification on the meaning of "series of transactions."

The SCC conducted the usual GAAR analysis by addressing the three questions mandated by the wording of section 245, as explained in *Canada Trustco*:

- Was there a "tax benefit"?

- If so, was the transaction giving rise to the tax benefit an avoidance transaction?

- If so, was the avoidance transaction abusive?

Tax benefit

The SCC reiterated its guideline from *Canada Trustco* that the burden is on the taxpayer to refute the Minister's assumption of the existence of a tax benefit. Since the TCC made a finding of fact that there was a tax benefit, the SCC could only overturn such a finding if Copthorne was able to show a palpable and overriding error. It was unable to do so.

The SCC stated that the existence of a tax benefit can be established by a comparison of the taxpayer's situation with an alternative arrangement, as long as it is one that "might reasonably have been carried out but for the existence of the tax benefit." (para. 35) In this regard, the Court held that the existence of a tax benefit can be determined by "considering what a corporation would have done if it did not stand to gain from the tax benefit." The Court concluded that the appropriate alternative arrangement for this purpose was a vertical amalgamation, which would have achieved the desired corporate consolidation.

The Court noted that "an amalgamation was necessary" to achieve the desired corporate objectives, and that the "only question was whether the amalgamation would be horizontal or vertical." (para. 37) Since the relevant difference between these two alternatives was the preservation of the PUC of the Former Subsidiary, it was determined that a tax benefit resulted from the series — being the tax savings arising from the PUC preserved by virtue of the horizontal rather than vertical amalgamation.

Interestingly, the Court did not hold that there was a tax benefit simply as a function of the tax savings arising from the PUC without regard to any comparison with an alternative transaction, and did not comment on this possibility. In *Canada Trustco,* the SCC made the following comments in this regard:

> [20] If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. In some other instances, it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement. For example, characterization of an amount as an annuity rather than as a wage, or as a capital gain rather than as business income, will result in differential tax treatment. In such cases, the existence of a tax benefit might only be established upon a comparison between alternative arrangements. In all cases, it must be determined whether the taxpayer reduced, avoided or deferred tax payable under the Act.

Avoidance transaction and series of transactions

Under subsection 245(3), a transaction is an avoidance transaction if it results in a tax benefit or if it is part of a series of transactions that results in a tax benefit and the transaction is not undertaken primarily for bona fide purposes other than to obtain the tax benefit. Since the Minister had assumed that the tax benefit in this case resulted from a series, the Court articulated the following analytical process:

> [40] Where, as here, the Minister assumes that the tax benefit resulted from a series of transactions rather than a single transaction, it is necessary to determine if there was a series, which transactions make up the series, and whether the tax benefit resulted from the series. If there is a series that results, directly or indirectly, in a tax benefit, it will be caught by s. 245(3) unless each transaction within the series could "reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain [a] tax benefit." If any transaction within the series is not undertaken primarily for a bona fide non-tax purpose that transaction will be an avoidance transaction.

More specifically, the Court reasoned that the various amalgamations and even the sale of the shares of the Former Subsidiary to Big City did not on their own result in any tax benefit (para. 42). The tax benefit here was only "realized" by virtue of the subsequent redemption of the Class D shares. Thus, it was necessary to determine whether that redemption was part of the series, because if it was not, then the series would not have resulted in a tax benefit.

The Court's reference here to "a bona fide non-tax purpose" is somewhat confusing, as is the Court's insertion of the word "[a]" instead of the word "the," which actually appears in the statute. The word "the" suggests that the transaction may possibly be tested only with reference to the particular tax benefit in question, and that it might not be an avoidance transaction with reference to that tax benefit even if it was undertaken or arranged primarily to achieve some other bona fide tax purpose — such as a separate and legitimate tax benefit. The use of the word "a," together with the reference to "a bona fide non-tax purpose," suggest to the contrary that there cannot be a bona fide tax purpose, and taken literally might even exclude a bona fide foreign tax purpose.

However, it seems clear from the definition in subsection 245(1) that a tax benefit can only include a Canadian federal tax benefit, such that a bona fide foreign tax purpose should qualify. Moreover, the Court suggests that the consolidation of gains and losses within a corporate group for purposes of "sheltering gains" may be a qualifying bona fide purpose in relation to testing the status of certain of the transactions that had been implemented, but not the sale of the shares of the Former Subsidiary to Big City, which was described as an "additional step" (para. 62).

In any event, subsection 248(10) expands the concept of a common law series by providing that the term "series of transactions" is deemed to include "any related transactions or events completed in contemplation of the series." In *Canada Trustco,* the SCC had stated that "in contemplation" is to be read not in the sense of actual knowledge but in the broader sense of "because of" or "in relation to" the series.

The SCC in *Copthorne* confirmed this approach and clarified that a "strong nexus" between the related transaction and the series is not required:

> 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 CTC 2552, at para. 62, aff'd 2007 FCA 236, 2007 DTC 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. (para. 47)

The SCC in *Canada Trustco* also took the view that the phrase "in contemplation of" can be applied to a series of transactions that occurred either before or after the related transaction. Copthorne asked the SCC to revisit this interpretation, arguing that the definition of "in contemplation" suggests consideration of a future event. The SCC acknowledged, among other things, that the more common use of the term "contemplation" is likely prospective, and that this was the sense in which this reference had been discussed in the Canadian Tax Foundation's 1988 Annual Conference Report by Michael Hiltz, then a director with the CRA. However, the Court relied on the earlier precedent in *Canada Trustco* as well as certain dictionary meanings of the word, which do not necessarily require that the thing contemplated be either in the future or the past, and concluded that it is more likely consonant with parliamentary intention to read subsection 248(10) both prospectively and retrospectively.

Therefore, the SCC agreed with the TCC and concluded that the redemption transaction was part of the same series as the prior sale and amalgamation, and that the series, including the redemption transaction, resulted in the tax benefit.

Avoidance transaction

Having concluded that there was a series of transactions that resulted in a tax benefit, the SCC went on to consider whether any transaction within the series was an avoidance transaction. Copthorne argued that each of the transactions in the series was undertaken for the purposes of simplifying the corporate structure and consolidating losses. The SCC disagreed, noting that the sale of the shares of the Former Subsidiary by Copthorne I to Big City was an unnecessary step in the process of simplification and consolidation, and was instead undertaken primarily for the purpose of preserving the PUC of the Former Subsidiary in order to achieve the tax benefit that was in question.

Abusive tax avoidance

(i) General principles

Before embarking on a detailed analysis of the statutory scheme with respect to the calculation of PUC, Justice Rothstein first set out some general principles, most of which flow from the SCC's decision in *Canada Trustco* and other prior judicial pronouncements:

- The terms misuse and abuse do not imply moral opprobrium. Taxpayers are entitled to select courses of action that will minimize their tax liability, subject to the GAAR.

- The GAAR is an unusual mechanism whereby the Courts have the duty of going behind the words of the legislation to determine the object, spirit or purpose of the relevant provisions. Therefore, courts must remember that the GAAR is "a provision of last resort."

- The GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear.

- The Minister must clearly demonstrate abuse, and the benefit of the doubt is given to the taxpayer.

- The first step in the analysis is to determine the "object, spirit or purpose of the provisions... that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids" (citing *Canada Trustco,* at para. 55).

- In a traditional statutory interpretation approach, the Court applies the textual, contextual and purposive analysis to determine what the words of the statute mean. In the GAAR context, the analysis is employed to determine the object, spirit or purpose of a provision. The search is for the rationale that underlies the words that may not be captured by the bare meaning of the words themselves.

- The second step in the analysis is to consider whether the transaction falls within or frustrates the identified purpose. "Where a transaction is part of a series, it must be viewed in the context of the series to enable the court to determine whether abusive tax avoidance has occurred. In such a case, whether a transaction is abusive will only become apparent when it is considered in the context of the series of which it is a part and the overall result that is achieved." (para. 71)

  This perspective reflects a reconciliation of the Court's statements about the GAAR in *Canada Trustco, Kaulius* and *Lipson,* which some have considered to be at variance with each other, if not, more seriously, not internally coherent. Here, the Court offers a test of whether a transaction is abusive based on the implications of all the components of the series taken as a whole judged with reference to their outcome.

- There will be a finding of abusive tax avoidance where (1) the transaction achieves an outcome the statutory provision was intended to prevent; (2) the transaction defeats the underlying rationale of the provision; or (3) the transaction circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose (citing *Canada Trustco,* at para. 45; *Lipson,* at para. 40).

- There is no distinction between an "abuse" and a "misuse."

With these principles in mind, Justice Rothstein commenced his abuse analysis with a discussion of the three provisions of the Act that were alleged to have been abused: subsections 89(1), 87(3) and 84(3).

Subsection 89(1) defines PUC and subsection 87(3) ensures that the total PUC of amalgamating corporations will be aggregated, except for the PUC attributable to "a share held by any other predecessor corporation." Subsection 84(3) deems any amount paid to a shareholder on a share redemption in excess of the PUC attributable to the share to be a deemed dividend. Of these provisions, the centre of Justice

Rothstein's analysis was subsection 87(3), since it is the only provision that deals specifically with the calculation of PUC on an amalgamation.

(ii) Text of subsection 87(3)

Subsection 87(3) is central to the SCC's disposition of this case. Its internal limitation on PUC "preservation" within its parenthetical clause, which the Court says "is at the centre of this appeal," made it relatively easy for the Court to discern legislative purpose and to detect the legislative scheme that defeated the planning in this case.

The SCC noted that the text of subsection 87(3) is clearly intended to limit PUC of the shares of the amalgamated corporation in a vertical amalgamation to the PUC of the shares of the amalgamating parent corporation. However, the important point is not simply that the rule exists and that it has this technical effect, but rather *why* the rule exists:

> [89] The text of s. 87(3) ensures that in a horizontal amalgamation the PUC of the shares of the amalgamated corporation does not exceed the total of the PUC of the shares of the amalgamating corporations. The question is why s. 87(3) is concerned with limiting PUC in this way. Since PUC may be withdrawn from a corporation without inclusion in the income of the shareholder, it seems evident that the intent is that PUC be limited such that it is not inappropriately increased merely through the device of an amalgamation.

The Court then distinguished between the PUC of a parent corporation and that of a subsidiary:

> [90] Section 87(3) also provides, in its parenthetical clause, that the PUC of the shares of an amalgamating corporation held by another amalgamating corporation is cancelled. In other words, in a vertical amalgamation, the PUC of inter-corporate shareholdings, such as exists in the case of a parent-subsidiary relationship, is not to be aggregated. Again, having regard to the fact that PUC may be withdrawn from a corporation not as a dividend subject to tax but as a non-taxable return of capital, the indication is that the parenthetical clause is intended to limit PUC of the shares of the amalgamated corporation to the PUC of the shares of the amalgamating parent corporation. While the creation of PUC in the shares of downstream corporations is valid, its preservation on amalgamation may be seen as a means of enabling the withdrawal of funds in excess of the capital invested as a return of capital rather than as a deemed dividend to the shareholder subject to tax.

With these comments, the Court also draws an important distinction between the validity of the creation of a tax attribute and the validity of its use. Thus, although a tax attribute may have been validly created — as it was in this case through bona fide cash contributions, unlike in certain other cases that may come to mind such as *2529-1915 Québec Inc. et al v the Queen* (2009 DTC 5023 (FCA)) — the subsequent use of that tax attribute may result in an abuse.

However, it seems fair to conclude that the foundation of the finding of abuse in this case was the duplication of the tax attribute, not simply its use after the value that gave rise to the tax attribute had been lost. Indeed, it should be emphasized that the loss here had accrued while the Former Subsidiary was under the Former Canadian Parent, such that it would have undermined not only the value of the Former Subsidiary relative to the PUC of its shares, but also the value of the Former Canadian Parent relative to the PUC of its own shares. Both of these tax attributes were carried forward into Copthorne III, but not even the Minister questioned the validity or use of the PUC of the Former Canadian Parent. This is consistent with the view that it should not be considered abusive for a taxpayer to reorganize a corporate group in order to align valid tax attributes with taxable values, as long as there is no inappropriate duplication or other such concern.

(iii) Context of subsection 87(3)

According to *Canada Trustco,* context involves a consideration of other relevant sections of the Act as well as permissible extrinsic aids. Relevant provisions are related because they are grouped together or work together to give effect to a coherent plan. Justice Rothstein considered the following contextual considerations:

- *The PUC scheme of the Act*
  The fact that subsection 84(3) provides that any payment on redemption of shares is only deemed to be a dividend where the amount paid is in excess of PUC explains why, in subsection 87(3), the PUC of shares of a subsidiary held by a parent are cancelled on a vertical amalgamation. Otherwise, according to the Court, "payments to shareholders on redemption of their shares in excess of the investment made with tax-paid funds could be made without liability for tax by the shareholder." (para. 94)

  It would be more accurate to state that otherwise payments to shareholders on redemption of their shares in excess of the investment made with tax-paid funds could be made without a *deemed dividend* rather than "without liability for tax by the shareholder," since the PUC would result in proceeds of disposition on redemption, which could give rise to a taxable capital gain, but the implications of the PUC with respect to capital gains is a matter that was dealt with separately by the Court.

  With respect to what was referred to as "the PUC scheme in the Act," the Court noted that the sections listed in subsection 89(1) that "grind" PUC are intended to prevent the preservation of PUC where the reliance on corporate stated capital would not achieve Parliament's intended purpose of allowing only for a return of tax-paid investment without an income inclusion. Subsection 87(3) is one of the grind provisions, so it is reasonable to conclude that it has the same purpose.

- *The principle of non-consolidation*
  Copthorne argued that the Act does not generally consolidate the results of different corporate entities or the PUC of different corporate entities. While Justice Rothstein acknowledged that the creation of PUC in the shares of a downstream corporation is not contrary to any policy of the Act, he also stated that this did not justify preservation of PUC when a parent and subsidiary are amalgamated.

- *The relevance of the capital gains scheme*
  Copthorne argued that the provisions of the Act dealing with capital gains and PUC are part of an integrated scheme that ensures that shareholders will be eventually subject to tax on their returns either as dividends or capital gains. Justice Rothstein was not convinced that the Act provides a "complete solution" such that all shareholder returns would be caught one way or another. Further, different tax rates may apply, and tax treaties may provide exemptions depending on the source.

- *The "in rem" nature of PUC*
  Copthorne argued that PUC is a tax attribute that does not generally change with a change in shareholder and so should not be traced back to an initial investment. Justice Rothstein acknowledged that this was generally true, but pointed out that subsection 87(3) is itself an example where the calculation of PUC *does* depend on the identity of the shareholder. Therefore it cannot be said that the treatment of PUC is never dependent on the identity of the shareholder.

  This is an interesting observation, but by the same token it might be noted that subsection 87(3) is concerned only with the identity of the shareholder at the time of the amalgamation, not at any particular time before the amalgamation. If the shares of the Former Subsidiary had fair market value equal to their PUC, then their sale to Big City for that amount would not have resulted in any change to the relationship between the value and the PUC of Copthorne I, such that it would have been necessary for this PUC to be preserved on the subsequent amalgamation in order for appropriate overall tax consequences to arise. Thus, it seems inappropriate to conclude that the decision in *Copthorne* would necessarily call into question the use of the PUC of a former subsidiary corporation in the absence of duplication and similar concerns (see also para. 121: “it is only where there is a finding of abuse that the corporate reorganization may be caught by the GAAR,” as well as the Court’s ultimate conclusions).

- *Absence of stop-PUC rules*
  Copthorne asserted that there are no specific “stop PUC” rules in the Act, which suggests that there is no general policy against PUC preservation. Justice Rothstein disagreed, noting the adjustment rules listed in subsection 89(1), including subsection 87(3). He stated that subsection 87(3) can be viewed as a stop-PUC rule that limits the aggregation of PUC in vertical amalgamations so that the PUC of an amalgamated corporation does not exceed the total of the “tax-paid investment” in the amalgamating corporations.

- *Implied exclusion*
  This principle of statutory interpretation provides, essentially, that if the legislature had meant to include a particular thing within the ambit of its legislation, it would have referred to that thing expressly. Based on this, Copthorne argued that since the PUC provisions in the Act are detailed, and since its actions were not specifically caught, there was no abuse of the purpose of those provisions. This was the position that found favour with the FCA in *Collins & Aikman.* Justice Rothstein disagreed, pointing out the very nature of a GAAR analysis involves going beyond the wording of the relevant provisions to determine the underlying object, spirit and purpose of the legislation. He observed that if a court were confined to a consideration of the provisions in question, without regard to their underlying rationale, the GAAR would be rendered meaningless.

(iv) Purpose of subsection 87(3)

Copthorne advanced a number of arguments with respect to the purpose of subsection 87(3), all of which were rejected by Justice Rothstein.

First, Copthorne asserted that subsection 87(3) is intended to ensure continuity and to “prevent corporate law increases to stated capital on horizontal amalgamations.” (para. 114) Rothstein accepted that continuity was a partial explanation for the wording of subsection 87(3), but noted that a provision could serve a variety of purposes. In this regard, he held that “[t]he parenthetical portion seeks to preclude corporations from preserving PUC of the shares of a subsidiary corporation on amalgamation with the parent corporation as that PUC reflects investment of the same tax-paid dollars as in the parent corporation.” (para. 115)

Copthorne also argued that subsection 87(3) is intended to maintain consistency between tax law and corporate law and takes its purpose from the corporate law cancellation of shares on a vertical amalgamation. Justice Rothstein rejected this argument on the basis that the purpose of subsection 87(3) cannot be taken from the purpose of the relevant corporate legislation, because the Act is not aimed at the same concerns. He referred to the Dickerson Report on the adoption of the *Canada Business Corporations Act* for the proposition that equivalent provisions in the corporate statues are concerned with preventing the dilution of the share capital of a corporation, which he distinguished from the concern under the Act with excessive preservation of PUC.

Copthorne submitted that there is no general policy against surplus stripping in the Act, and therefore the object, spirit and purpose of subsection 87(3) cannot be to prevent surplus stripping by the aggregation of PUC. Justice Rothstein agreed that it is not permissible to base a finding of abuse on some broad statement of policy, such as anti-surplus stripping, that is not apparent from the provisions at issue. However, he pointed out that the tax purpose identified in his reasons was not based on a broadly stated policy, but on “an examination of the PUC sections of the Act," and that this approach "addresses the rationale of the PUC scheme specifically in relation to amalgamation and redemption." (para. 118)

Copthorne raised a concern that if there was a finding of abusive tax avoidance in this case, taxpayers would face uncertainty because they would not be able to determine whether PUC that had been validly created in a downstream investment would be subject to cancellation if it were sold to a third party. Justice Rothstein made short shrift of this argument, noting that if a share acquisition takes place primarily for a non-tax purpose, there will be no avoidance transaction and the GAAR will not apply.

Justice Rothstein concluded that, having regard to the text, context and purpose of s. 87(3), "the object, spirit and purpose of the parenthetical portion of the section is to preclude preservation of PUC of the shares of a subsidiary corporation upon amalgamation of the parent and subsidiary where such preservation would permit shareholders, on a redemption of shares by the amalgamated corporation, to be paid amounts as a return of capital without liability for tax, in excess of the amounts invested in the amalgamating corporations with tax-paid funds." (para. 122)

(v) Was there an abuse?

Proceeding from the premise that the transfer of the shares of the Former Subsidiary to Big City was an avoidance transaction, the question addressed by the Court was whether this transaction "frustrates or defeats the object, spirit or purpose" of subsection 87(3) (para. 125).

The Court concluded that it did: "The tax-paid investment here was in total $96,736,845. To allow the aggregation of an additional $67,401,279 to this amount would enable payment, without liability for tax by the shareholders, of amounts well in excess of the investment of tax-paid funds, contrary to the object, spirit and purpose or the underlying rationale of subsection 87(3)." (para. 127)

However, the Court went on to observe that "a series of transactions that results in the 'double counting' of PUC is not in itself evidence of abuse." (para. 127) This is perhaps one of the more difficult parts of the reasons to understand. This statement is made in the following context:

> While a series of transactions that results in the "double counting" of PUC is not in itself evidence of abuse, this outcome may not be foreclosed in some circumstances. I agree with the Tax Court's finding that the taxpayer's "double counting" of PUC was abusive in this case, where the taxpayer structured the transactions so as to "artificially" preserve the PUC in a way that frustrated the purpose of s. 87(3) governing the treatment of PUC upon vertical amalgamation.

It seems difficult to understand what was so "artificial" about the preservation of the PUC in this case. It may have been tax motivated, but there was no suggestion that it was a sham or based on fictitious, self-cancelling or circular transactions, or that it was "window dressing." If the artificiality of this preservation of PUC is grounded in the existence of the losses, then what about the PUC of the Former Canadian Parent, which was also preserved, and not questioned?

It seems arguable that the preservation of the PUC of the Former Canadian Parent was not questioned because its use reflected what was regarded as the investment of tax-paid value, even if that value was subsequently lost. Thus, it seems arguable that the preservation of the PUC of the Former Subsidiary in this case was regarded as being "artificial" because it would have permitted shareholders to be paid amounts as a return of capital in excess of the actual amounts invested by them with tax-paid funds.

Conclusion

On the whole, the case is largely an affirmation of the GAAR analysis in *Canada Trustco,* and the result in this particular case is not that surprising since there was a particular statutory provision (s. 87(3)) on which the Court could focus. What is of greater interest are the comments made by Justice Rothstein on the general scheme of the PUC provisions of which s. 87(3) is a part, specifically that they preclude the preservation of PUC where such preservation would allow for a withdrawal, as a return of capital, of an amount in excess of the investment made with tax-paid funds.

Learn more

For more information, please contact your Ernst & Young or Couzin Taylor advisor, or one of the following professionals.

Toronto

Derek Alty
+1 416 943 3860 | derek.g.alty@ca.ey.com

Yi-Wen Hsu
+1 416 943 5310 | yi-wen.hsu@ca.ey.com

Heather Kerr
+1 416 943 3162 | heather.i.kerr@ca.ey.com

Daniel Sandler
+1 416 943 4434 | daniel.sandler@ca.ey.com

Scott Wilkie
+1 416 943 2765 | scott.wilkie@ca.ey.com

Ottawa

Jennifer Smith
+1 613 598 4355 | jennifer.j.smith@ca.ey.com

Roger Taylor
+1 613 598 4313 | roger.taylor@ca.ey.com

Montreal

Angelo Nikolakakis
+1 514 879 2862 | angelo.nikolakakis@ca.ey.com

Louis Tassé
+1 514 879 8070 | louis.tasse@ca.ey.com

Calgary

Mark Coleman
+1 403 206 5147 | mark.coleman@ca.ey.com

Karen Nixon
+1 403 206 5326 karen.r.nixon@ca.ey.com

David Robertson
+1 403 206 5474 david.d.robertson@ca.ey.com

New York – Canadian Tax Desk

Nik Diksic
+1 212 773 3330 nik.diksic@ey.com

London, UK – Canadian Tax Desk

Christian Desjardins
+44 (0) 207 951 0802 | cdesjardins@uk.ey.com

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