

# Can't Always Get What You Want: 2007 Tax Cases

by David Louis, B. Com., J.D., C.A., Tax Partner  
Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

(\*This release is based on an article published in Tax Notes #540, November 2008, CCH Canadian Limited.)

This old saying may be an apt way to sum up the tax cases that came down in 2007. With few exceptions<sup>1</sup>, the big cases went against taxpayers, not only in respect of GAAR but other areas as well. Here is a rundown of the most important ones – and why they are so troublesome.

**Copthorne**<sup>2</sup> is a GAAR case. In essence it involved what was perceived to be a double count of paid-up capital. Layers of paid-up capital can occur as a result of the injection of capital through tiers of subsidiaries when the bottom tier subsidiary turns out to be unsuccessful. The judge found that a reorganization to sequester the doubled-up paid-up capital in one corporation - to facilitate an offshore distribution by it - was abusive.

Because paid-up capital transactions are somewhat outside of the tax planning mainstream, it is not the attack on the transaction itself that is troublesome<sup>3</sup>. What is really problematic is the court's approach to the "series of transactions" concept, which applies to GAAR, as well as a number of other key income tax provisions<sup>4</sup>. In *Copthorne*, the paid-up capital was preserved "just in case": at the time of the reorganization, there were no plans on the horizon to take advantage of the doubling-up effect – the transaction that did so was unforeseen at the time. Nonetheless, the judge found that the subsequent transaction was part of the same series of transactions as the previous reorganization, because there was a "strong nexus" between the two transactions (as seems to be required under case law), and the later transaction "contemplated"<sup>5</sup> the previous series in the sense that the parties "had knowledge of" the series which set up the augmented paid-up capital.

Practitioners are asking themselves, where does this stop, say, if a transaction occurs years in the future? *Copthorne* seems to allow the linking of unforeseen future transactions as part of a current series of transactions or events. And a future transaction, though unforeseen at the time of the original series, can nonetheless have a “strong nexus” with it.

### Paint It Black

*Lipson*<sup>6</sup>, a Federal Court of Appeal decision, involves an old mortgage interest deductibility flip: a spouse borrowing money to buy unlevered shares of a family company from her husband. Denying the interest deduction, the case seems to have broadened the test for determining when a series of transactions will be considered to be abusive by having regard to the purpose of the series taken as a whole. This has been perceived as coming perilously close to an approach that looks at substance or “economic reality” of the transactions to override legal relationships. Translation? It throws all sorts of interest deductibility strategies into jeopardy. For example, a recent article questioned whether *Lipson* might knock out a “Singleton” transaction – i.e., a “partnership capital rollaround”, such as where a professional partner temporarily withdraws his or her capital for personal use, then borrows to replace it. The author concludes that “tax planners will have to reconsider strategies that have been undertaken to convert otherwise non-deductible interest into deductible interest”.<sup>7</sup>

*Lipson* will be heard by the Supreme Court some weeks from now (April 23<sup>rd</sup> is the tentative hearing date). I have heard that the lawyer handling the appeal will ask the court to provide some general guidelines as to the application of GAAR. No wonder. The uncertainty that was predicted for this anti-avoidance rule has come to pass. But what is remarkable is that it can apply to commonplace financial planning transactions involving income splitting and interest-deductibility manoeuvres - the kind of stuff I used to knock off in an afternoon in my previous life as a pop-tax writer.

**Gimme Shelter.** Even King and Bay thinking has come under attack. In the area of tax shelters, the conventional wisdom had been that the mathematical test for the application of the tax shelter rules - do the deductions<sup>8</sup> in the first four years equal or exceed the cost of the property in question<sup>9</sup>? - must be the subject of a “representation” – in the legal sense of the word, as in a “representation or warranty” in a contract. In 2007, the courts have poured cold water on this. In fact, there have recently been three key unfavourable verdicts in respect of tax shelters: *Maege*<sup>10</sup>, *Tolhoek*<sup>11</sup>, and most significantly, *Baxter*<sup>12</sup>. In that case, the Court of Appeal ascribed a non-technical meaning to the representation concept<sup>13</sup>. “Representations”<sup>14</sup> need only to be “communicated” or “announced” (presumably, including verbally) to “prospective purchasers” – and not necessarily to the particular taxpayer<sup>15</sup>. So in a syndicated investment, the tax shelter rules may apply to a particular investor even if there has been no mention of the tax benefits – to that taxpayer.

Once again, tax drones are scratching their heads, wondering where all this ends. For example, I have had discussions with practitioners who are concerned that the tax shelter rules may apply to financing transactions involving a professional partnership.

### Wild Horses

**2530-1284 Québec Inc**<sup>16</sup>, aka “Langlois” and/or “Faraggi”, involved a stock-dividend strategy to create capital dividend accounts which were “sold” to corporations. The case was particularly well-known in the Montreal area because it involved a large law office in that city - and some other factors which converged to make case particularly “noteworthy”. While the case against the “buyers” of the capital dividend accounts had been resolved years ago, *Faraggi* itself focused on the practitioners themselves – who did not follow the edict about shoemakers, and took who their profits in the form of tax-free capital dividends. The judge showed little sympathy to what he may have perceived as “big firm” antics. He held that the doctrine of sham – which many

practitioners thought was ancient history – applied to turn the capital dividends into taxable business profits.<sup>17</sup> As has been observed by my MERITAS colleague, Tim Huot<sup>18</sup>, the sham doctrine<sup>19</sup> was expanded by including an additional element in the doctrine, namely an abuse of the provisions of the *Income Tax Act*, contrary to their object and spirit.

Apart from this, what I find troubling is the attack on the “papering” of the transaction, particularly the daylight loans which were used. The judge attacked the loans on the basis that they were invalid, among other things, because there was no security or interest charged.<sup>20</sup> Trouble is, temporary loans and the like are common in tax-planning. Once again, practitioners are left to wonder where this sort of thing stops – when will a loan without commercial terms be vulnerable to an attack? I might also point out that the approach in *Faraggi* seems to be completely at odds with the *Howson* case<sup>21</sup>, involving whether there was a valid loan to a trust (so that subsection 75(2) did not apply). In *Howson*, the court specifically observed that a genuine loan does *not* require interest or security.

Does *Faraggi* signal the resurrection of the sham doctrine, a second line of attack besides GAAR – as well as throw the papering of transactions into jeopardy – or is it a “perfect storm” where a number of factors added up to what will be remembered as an anomalous judgment?

We will find out more when the appeal is heard. In *Baxter*, leave to appeal was recently denied by the Supreme Court of Canada, but the other three featured cases in this article are under appeal. Will 2008 bring better outcomes? You can't always get what you want. But if you try sometimes, you just might find, you get what you need.

---

<sup>1</sup> Perhaps the most important being *The Queen v. MIL Investments (SA)*, 2007 FCA 236, which held that GAAR does not apply to treaty shopping.

---

<sup>2</sup> *Copthorne Holdings Ltd. v. The Queen*, 2007 DTC 1230, TCC.

<sup>3</sup> Although it seems to me that similar effects - and issues - can arise from cost base created in a similar manner.

<sup>4</sup> Subsections 55(2) and 69(11) as well as the subsection 88(1) bump, to name a few.

<sup>5</sup> Per subsection 248(10), a series of transactions or events is deemed to include any related transactions or events completed in contemplation of the series.

<sup>6</sup> *Lipson v. The Queen*, 2007 FCA 113.

<sup>7</sup> "Reconciling *Singleton* and *Lipson*", Karen Yull, *Tax Hyperion*, Vol. 4 No. 10, October 2007, Carswell.

<sup>8</sup> Amounts represented to be deductible.

<sup>9</sup> Net of "prescribed benefits". Basically, this refers to potential financial assistance to limit losses, as well as "limited recourse amounts" per Regulation 231(6.1).

<sup>10</sup> *Norma Maege v. The Queen*, 2006 TCC 117, TCC, affirmed, 2007 FCA 125. This case indicated that one could make representations to oneself. For a discussion reconciling this concept with the concept of representation to a "prospective purchaser" in *Baxter*, see "Tax Shelters – Presumed Cognizant?" Francois Giroux, *Tax Topics* No. 1837, May 24, 2007.

<sup>11</sup> *Bert Tolhoek v. The Queen*, 2006 TCC 681, TCC. In *Tolhoek*, Campbell, J. suggested that, because the case involved aspects of the tax shelter provisions (the applicability of the limited recourse indebtedness rules in section 143.2), the test of bona fide arrangements for repayment should be interpreted more stringently than similar provisions relating to shareholder loans. Query whether the Federal Court of Appeal implicitly took a similar approach to the meaning of "representation" in *Baxter*.

<sup>12</sup> *Baxter, R.D. v. The Queen*, 2007 FCA 172 (2007 DTC 5199); reversing 2006 DTC 2642 (TCC).

<sup>13</sup> For another discussion of *Baxter*, see "Get a Tax Shelter Number: *Baxter*", John Jakolev and Graham Turner, *Canadian Tax Highlights*, Volume 15, Number 6, June 2007. The authors state that it was believed that the term "representation" has a distinct legal meaning—a statement of fact made to induce another to enter into a contract.

<sup>14</sup> Which are made by the "promoter", as defined in section 237.1; see paragraph 44.

<sup>15</sup> Thus, in *Maege*, the Federal Court of Appeal indicated that, once the tax consequences had been "announced", the fact that the appellant did not make statements to herself is irrelevant.

<sup>16</sup> 2007 DTC 911.

---

<sup>17</sup> As the transaction pre-dates GAAR, that weapon was not available to the CRA.

<sup>18</sup> Of BCF, Montreal. See "Sham - As Bad As It Gets", Tax Topics No. 1857, October 11, 2007.

<sup>19</sup> I.e., acts done or documents executed by the parties which are intended to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. In short, the classic sham doctrine is rooted in the concept of deceit.

<sup>20</sup> The court stated:

The bank was under no obligation to these corporations that the corporations would have free use of the funds for any given time. The bank had no security and without security would not be prepared to lend money to the corporations. If the \$10,000 paid to the bank were interest, as claimed by the appellants, one would expect that there would have been a contract of loan between the corporations and the bank under the bank's usual terms providing for interest. There was no such contract. The \$10,000 was simply an accommodation charge. I have not been provided with any evidence that the \$10,000 related to a charge for interest on a loan of \$10,000,000 for a period of less than one day. [Paragraph 90]

<sup>21</sup> *Howson v. The Queen*, 2007 DTC 141, TCC.