CROWN WINS GAAR CASE IN THE SUPREME COURT OF CANADA: *COPTHORNE HOLDINGS LTD. V. THE QUEEN*

BY DAVID E. SPIRO

On December 16, 2011, the Supreme Court of Canada released its latest General Anti-Avoidance Rule (GAAR) decision in *Copthorne Holdings Ltd. v. Canada*. The appeal was heard on January 21, 2011 by all nine of the Justices (Chief Justice McLachlin, Justice Binnie, Justice LeBel, Justice Deschamps, Justice Fish, Justice Abella, Justice Charron, Justice Rothstein and Justice Cromwell). Since the date of the hearing, Justices Binnie and Charron have retired. This was the fourth GAAR appeal heard by the Supreme Court (the earlier cases were *Canada Trustco Mortgage Co. v. Canada*, *Mathew v. Canada* and *Lipson v. Canada*).

With Justice Rothstein writing for a unanimous Court, the taxpayer's appeal was dismissed. In so doing, the Court arrived at the same result as the Tax Court of Canada and the Federal Court of Appeal while, at the same time, providing important guidance for corporate Canada on the interpretation and application of the GAAR particularly in the context of reorganizations and distributions. The clarity and precision of Justice Rothstein's reasons should be welcomed by the business community, though the result in this particular case was unfavourable to the taxpayer.

If $96 million was contributed as capital, how can a taxpayer withdraw more than that amount as a tax-free return of capital? Does the GAAR preclude such a result? That the Court's answer to the latter question was "yes" should not be regarded as a general defeat for tax planners. The encouraging news for tax planners appears most clearly in two paragraphs of the reasons (note the deliberate use of the word "and" in paragraph 121):

> [121] Copthorne also argues that the Act does not contain a policy that parent and subsidiary corporations must always remain as parent and subsidiary. I agree. There is no general principle against corporate reorganization. Where corporate reorganization takes place, the GAAR does not apply unless there is an avoidance transaction that is found to constitute an abuse. Even where corporate reorganization takes place for a tax reason, the GAAR may still not apply. It is only when a reorganization is primarily for a tax purpose *and* is done in a manner found to circumvent a provision of the *Income Tax Act* that it may be found to abuse that provision. And it is only where there is a finding of abuse that the corporate reorganization may be caught by the GAAR.
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> [123] While Parliament's intent is to seek consistency, predictability and fairness in tax law, in enacting the GAAR, it must be acknowledged that it has created an unavoidable degree of uncertainty for taxpayers. 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.

Background

In a nutshell, a non-resident invested $96 million in a Canadian holding company. Those funds were then used to purchase Canadian portfolio investments and Canadian real property. There were a number of subsidiaries and other affiliated corporations through which those investments were made. About $67 million of that $96 million was, in turn, contributed to a

subsidiary. Following a 1993/1994 series of transactions, that $67 million of PUC was preserved which resulted in aggregate paid-up capital (“PUC”) as between the two companies of $163 million ($96 million plus $67 million). That amount of PUC was later utilized, in another transaction, to permit the non-resident to withdraw $142 million from Canada free of withholding tax.

It was a set of 1994 proposals by the Department of Finance relating to the foreign accrual property income (“FAPI”) rules which caused the non-resident to monetize certain of his holdings. This was done by redeeming $142 million of shares without payment of Canadian withholding tax. What troubled the Minister of National Revenue was that the original investment was $96 million - any amount withdrawn in excess of the original capital contribution ought to have been considered a deemed dividend subject to Canadian withholding tax.

Having made the decision to divest those holdings, the taxpayer’s choice was whether to organize such a divestiture by way of a horizontal amalgamation or a vertical amalgamation. If divestiture was to be accomplished by way of a horizontal amalgamation, the taxpayer believed that the total amount that could be removed free of Canadian withholding tax was $163 million ($96 million plus $67 million) as subsection 87(3) of the *Income Tax Act* does not provide for horizontally amalgamated corporations to lose their PUC as would have been the case on a vertical amalgamation (in the latter case, the PUC of the subsidiary would disappear on the amalgamation as the shares in the subsidiaries would necessarily have been cancelled).

There were two sets of transactions which the Crown had to connect in order to succeed under the extended definition of “series” in subsection 248(10) of the *Income Tax Act*. There was a series of transactions in 1993/1994 (the sale of VHHC Holdings to Big City, and the subsequent amalgamation of VHHC Holdings with Copthorne I to form Copthorne II) which achieved the result of preserving $67 million of PUC in the subsidiary. Then there was a transaction in 1995 (Copthorne III redeemed its shares without its shareholder incurring an immediate tax liability) which actually utilized the $67 million of PUC which had been preserved under the 1993/1994 series of transactions.

Was There a Tax Benefit?

In paragraph 37, Justice Rothstein explains why there was clearly a tax benefit:

> [37] . . . . The only question was whether the amalgamation would be horizontal or vertical. As the Tax Court judge pointed out, the vertical amalgamation would have been the simpler course of action. It was only the cancellation of PUC that would arise upon a vertical amalgamation that led to the sale by Copthorne I of its shares in VHHC Holdings to Big City. To use the words of Professor Duff, “but for” the difference in how PUC was treated, a vertical amalgamation was reasonable.

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Was the Transaction Giving Rise to the Tax Benefit an Avoidance Transaction?

As there was no question about the tax benefit, the first issue was whether there was an "avoidance transaction". According to the Crown, the avoidance transaction was the 1993/1994 series of transactions which preserved the $67 million of PUC in the subsidiary as that series of transactions resulted in a tax benefit as part of a larger series (including the 1995 redemption transaction) in which the $67 million of PUC was actually utilized.

One of the Supreme Court's concerns during oral argument was whether the 1993 series of transactions preserving $67 million of PUC was undertaken primarily for *bona fide* (i.e non-tax) purposes. The taxpayer argued that it would have been imprudent, from a business perspective, to have squandered (or failed to preserve) all of the available PUC. There is no relevant nexus, the taxpayer argued, between the 1993/1994 series of transactions and the 1995 redemption transaction.

During oral argument, considerable time was spent on the question of whether the extended meaning of "series of transactions" in subsection 248(10) of the *Income Tax Act* could be used to connect transactions where the first series was not undertaken specifically in order to facilitate the second transaction. The taxpayer argued that the 1995 series could not have been undertaken "in contemplation of" the 1993/1994 series as the 1995 series was prompted by an intervening event (i.e., the proposed change to the FAPI rules).

Justice Rothstein held as follows:

> [48] The Tax Court judge was aware both of the intervening introduction of the FAPI rule changes, as well as the time interval between the sale and amalgamation in 1993 and 1994 and the redemption in 1995 (para. 38). Copthorne argued that these intervening events broke the purported series. The Tax Court judge agreed that the test should not catch "transactions that are only remotely connected to the common law series" (para. 39). Nonetheless, she found that there was a "strong nexus" between the series and the subsequent redemption, because "the Redemption . . . was exactly the type of transaction necessary to make a tax benefit a reality based on the preservation of the PUC" (para. 40). The Federal Court of Appeal upheld this conclusion, finding that there was no palpable and overriding error of fact. I would also uphold the Tax Court judge's conclusion for the same reason.

At paragraph 56, Justice Rothstein concluded that, as stated by the Court in *Canada Trustco*, "the language of s. 248(10) allows either prospective or retrospective connection of a related transaction to a common law series and that such an interpretation accords with the Parliamentary purpose." He therefore agreed with the Tax Court and Federal Court of Appeal 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." [paragraph 58]

Justice Rothstein's observations here should be of considerable comfort to tax planners who will look to paragraph 47 in particular:

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> [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.

Tax planners now know that a transaction will not fall within a series of transactions unless it was undertaken "because of" or "in relation to" the series. Such a test is far superior to the "mere possibility" standard.

On the "avoidance transaction" issue as a whole, Justice Rothstein concluded that:

> [60] The Tax Court judge found that the 1993 sale of VHHC Holdings shares from Copthorne I to Big City was an avoidance transaction. The Federal Court of Appeal agreed.
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> [61] The sale preserved the PUC of the VHHC Holdings shares when VHHC Holdings and Copthorne I were amalgamated to form Copthorne II, which allowed for the subsequent redemption of Copthorne III shares without liability for tax. This is a tax purpose.
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> [62] Copthorne argues that the transactions were undertaken for the purposes of simplifying the Li Group companies and using the losses within the four amalgamated companies to shelter gains also within the four amalgamated companies. While simplification and sheltering gains may apply to the other transactions, they do not explain the sale of VHHC Holdings shares to Big City. As the Tax Court judge found, the share sale introduced an additional step into a process of simplification and consolidation. A vertical amalgamation would have resulted in the same simplification and consolidation. Moreover, Copthorne has not shown why sheltering gains using losses within the four companies would not have been possible if the companies were amalgamated vertically.
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> [63] I see no error in the finding of the Tax Court judge that the sale of the VHHC Holdings shares from Copthorne I to Big City was not primarily undertaken for a *bona fide* non-tax purpose. The burden was upon Copthorne to prove the existence of a *bona fide* non-tax purpose (*Trustco* at para. 66), which it failed to do. Thus, I would affirm her finding that the sale of the VHHC Holdings shares to Big City was an avoidance transaction.
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> [64] Because there was a series of transactions which resulted in a tax benefit, the finding that one transaction in the series was an avoidance transaction satisfies the requirements of s. 245(3).

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Was the Avoidance Transaction Giving Rise to the Tax Benefit Abusive?

The Crown argued that the role of PUC in the *Income Tax Act* is to "benchmark" the total amount that may be repaid to shareholders tax free. It argued that the taxpayer abused, among other provisions, subsection 87(3) of the *Income Tax Act* by undertaking a horizontal amalgamation as it did. The purpose of that provision, the Crown argued, is to prescribe how a taxpayer is to compute PUC on <u>all</u> amalgamations - it instructs taxpayers that they may not amalgamate a parent and a subsidiary without eliminating the PUC of the subsidiary. The Crown contended that this was, at the end of the day, an amalgamation of a parent and subsidiary to which subsection 87(3) was intended to apply. The Crown argued that the "result" was a vertical amalgamation and that the GAAR is a "results-based" test. The result was a vertical amalgamation "by another name" and that is how subsection 87(3) was abused. The taxpayer "inserted" an avoidance transaction (the 1993 series) which resulted in a vertical amalgamation being done horizontally. In the final analysis, a subsidiary (with $67 million of PUC) had been amalgamated with the parent (with $96 million of PUC). As subsection 87(3) is intended to prevent the duplication of PUC, a transaction that avoids the effect of subsection 87(3), but which nevertheless achieves PUC duplication, is abusive and, therefore, properly subject to the GAAR.

Justice Rothstein reviewed the purpose of subsection 87(3) and held as follows:

> [88] In any GAAR case the text of the provisions at issue will not literally preclude a tax benefit the taxpayer seeks by entering into the transaction or series. This is not surprising. If the tax benefit of the transaction or series was prohibited by the text, on reassessing the taxpayer, the Minister would only have to rely on the text and not resort to the GAAR. However, this does not mean that the text is irrelevant. In a GAAR assessment the text is considered to see if it sheds light on what the provision was intended to do.
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> [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.
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> [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.

In arguing why such a result was not abusive, the taxpayer had asked the Court to bear in mind the entire scheme of the *Income Tax Act*, including capital gains tax. The taxpayer noted that a capital gain of some $150 million was realized under the *Income Tax Act* on the disposition of the taxpayer's Canadian investment portfolio. It was argued that the fact that there was no Canadian tax on that gain by virtue of the Canada-Netherlands Tax Convention was irrelevant – it was Canada's decision not to tax such gains in the context of the Treaty.

Justice Rothstein responded to this argument as follows:

> [100] Copthorne argues that the provisions of the Act relating to capital gains and PUC are part of a single integrated scheme that "provides a complete solution to this situation" and ensures that tax eventually is applied to shareholder returns, either as a deemed dividend or as a capital gain (A.F., at para. 69).
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> [101] On the basis of the arguments made, I have not been convinced to accept Copthorne's position. Capital gains or losses are calculated in relation to the adjusted cost base ("ACB") of a share, not its PUC. While PUC relates to shares, ACB relates to a specific taxpayer. PUC depends on the amount initially invested as capital, whereas the ACB reflects the amount the current shareholder paid for the shares. In some cases the ACB and PUC may be the same, but in others they may not be. In the case of shares acquired from a prior shareholder it will be unlikely that the ACB will be equal to the PUC.
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> [102] I would hesitate to conclude that the Act contains a "complete solution" whereby any withdrawal that would not be caught under the PUC-deemed dividend scheme would be caught instead by the capital gains scheme. An amount returned to a shareholder on a share redemption may be considered a return of capital rather than a deemed dividend under s. 84(3). However, the return of capital may reflect either a capital gain or a capital loss, which would be determined in relation to the ACB of the shareholder.
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> [103] Further, the tax rates applicable to dividends and capital gains are not identical. With respect to non-resident shareholders, tax treaties may exempt capital gains from tax but not dividends. This suggests that the capital gains scheme is not an automatic proxy for the PUC-deemed dividend scheme, whereby a taxpayer will always be liable for the same tax under one tax scheme or the other on a redemption. Copthorne did not cite any sources directly on point. The capital gains issue was not addressed by either the Tax Court judge or the Federal Court of Appeal. In the circumstances, Copthorne has not substantiated this argument sufficiently that it can be accepted in this case.

The taxpayer contended that no one would squander a valuable "corporate attribute" such as PUC by undertaking a vertical amalgamation in which the $67 million of PUC would have vanished. There was no abuse here as Parliament specifically described in subsection 87(3)

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a set of circumstances in which PUC would be reduced (i.e., on a vertical amalgamation) but provided no reduction of PUC on a horizontal amalgamation.

On the overall "abuse" analysis, Justice Rothstein concluded as follows:

> [124] Copthorne agrees that s. 87(3) would have led to a cancellation of the PUC of the VHHC Holdings shares if it had been vertically amalgamated with Copthorne I. Instead of amalgamating the two companies, Copthorne I sold its VHHC Holdings shares to Big City, in order to avoid the vertical amalgamation and cancellation of the PUC of the shares of VHHC Holdings. The transaction obviously circumvented application of the parenthetical words of s. 87(3) upon the later amalgamation of Copthorne I and VHHC Holdings.
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> [125] The question is whether this was done in a way that "frustrates or defeats the object, spirit or purpose" of the parenthetical words of s. 87(3) (*Trustco*, at para. 45). In oral argument, Copthorne argued that by leaving VHHC Holdings and Copthorne in a vertical structure would be "throwing away" the PUC upon amalgamation. It argued that the purpose of s. 87(3) cannot require shareholders to throw away valuable assets. However, it must be remembered that there has been a finding of tax benefit (protecting the PUC of the shares of VHHC Holdings of $67,401,279 from withholding tax upon Copthorne III redeeming a large portion of its shares) and an avoidance transaction (the sale of VHHC Holdings from Copthorne I to Big City). The GAAR analysis looks to determine whether the avoidance of a vertical amalgamation and preservation of the VHHC Holdings' PUC of $67,401,279 circumvented s. 87(3), achieves an outcome s. 87(3) was intended to prevent or defeats the underlying rationale of s. 87(3). If such a finding is made, the taxpayer is not "throwing away" a valuable asset. It is the application of the GAAR that applies to deny the benefit of that "asset" to the taxpayer.
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> [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.
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> [127] I am of the opinion that the sale by Copthorne I of its VHHC Holdings shares to Big City, which was undertaken to protect $67,401,279 of PUC from cancellation, while not contrary to the text of s. 87(3), does frustrate and defeat its purpose. 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 s. 87(3). 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. The sale of VHHC Holdings shares to Big City circumvented the parenthetical words of s. 87(3) and in the context of the series of which it was a part, achieved a result the section was intended to prevent and thus defeated its underlying rationale. The transaction was therefore abusive and the assessment based on application of the GAAR was appropriate.

Although the decision is a defeat for a taxpayer on the facts of the case, the approach used by the Court (particularly the cautionary notes struck in paragraphs 121 and 123) along with the clarity and precision of the reasons written by Justice Rothstein (as adopted by the entire Court) should be generally reassuring to the business community. Corporate Canada will still be able to engage in tax planning to advance business objectives if the transactions contemplated are adequately supported by non-tax purposes and if the results of those transactions do not circumvent any provisions of the *Income Tax Act* that are clearly aimed at precluding those results.