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FORM STILL MATTERS. . . RIGHT?!

— S. Sebastian Elawny and Sophie Virji, Associates with the Calgary office of Dentons Canada LLP

It has long been the subject of tax litigation in Canada as to the role to be played by the "economic reality" or "economic substance" in a transaction. Canadian courts have generally been consistent in concluding that legal form is what matters, subject to a few limited exceptions. The decision of the Federal Court of Appeal ("FCA") in *Global Equity Fund Ltd. v. Her Majesty the Queen*[1] creates some confusion in the law in this area.

The *Shell* Case — Form Matters

The leading case on the relevance of the "economic realities" is *Shell Canada Ltd. v. Her Majesty the Queen*.[2] In that case, the Supreme Court of Canada ("SCC") explained that the legal form of a transaction is to be respected unless a specific provision of the *Income Tax Act* (the "Act") provides otherwise or the relationship is a *sham* (i.e., the label attached by the taxpayer to the particular transaction does not properly reflect the actual legal relationship).[3] Since very few provisions in the Act require consideration of the economic realities of a transaction or arrangement,[4] the only relevant consideration is whether the legal form of a transaction represents the true nature of the transaction; where this is the case, the law has been clear that such legal form and the *bona fide* legal relationships must be respected.

In *Shell,* the SCC explained that courts are not to look through transactions and impose tax according to their economic and commercial effects as "a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done . . .".[5] In concluding on the "economic realities" issue, the SCC stated that:

> [45] . . . The court's role is to interpret and apply the Act as it was adopted by Parliament. *Obiter* statements in earlier cases that might be said to support a broader and less certain interpretive principle have therefore been overtaken by our developing tax jurisprudence. Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.
>
> [46] Inquiring into the "economic realities" of a particular situation, instead of simply applying clear and unambiguous provisions of the Act to the taxpayer's legal transactions, has an unfortunate practical effect. This approach wrongly invites a rule that where there are two ways to structure a transaction with the same economic effect, the court must have regard only to the one *without* tax advantage. With respect, this approach fails to give appropriate weight to the jurisprudence of this Court providing that, in the absence of a specific bar to the contract, taxpayers are entitled to structure their affairs in a manner that reduces the tax payable . . .

The point the Court was trying to make was that the principle from *Inland Revenue Commissioners v. Duke of Westminster*,[6] which essentially states that taxpayers are entitled to arrange their affairs so as to minimize tax liability, is still alive and well in Canada. To that end, the SCC has repeatedly stated that neither the complexity of a taxpayer's affairs[7] nor the motive (even where that motive is a purely tax motive) for structuring their affairs in a particular way[8] is relevant in determining whether a transaction or arrangement is valid under the Act.

Consequently, absent *sham,* the legal constructs of a transaction should be respected unless a provision of the Act specifically requires consideration of the economic realities of the transaction.[9]

Pre-*Shell* — Origins of "Economic Realities"

In order to understand the importance of the strong language adopted by the SCC in the *Shell* decision, it is necessary to review the state of the law prior to that decision.

While the courts have struggled with a number of substance analysis tests over the years,[10] the door to considering economic realities was originally opened by the SCC in *Bronfman Trust v. R.*[11] In *obiter dicta* to that case, the Court expressed a desire to expand the review of a transaction to consider the true commercial and practical nature of a taxpayer's transactions with the ultimate objective of achieving tax equity amongst sophisticated and unsophisticated taxpayers.[12] Citing *Bronfman Trust*, *supra*, with approval, the SCC in *Tennant v. R.*[13] adopted an economic reality test.

As a result, the lower courts began to consider the economic realities doctrine in deciding whether a taxpayer's transactions or arrangements were valid under the Act. A number of these cases, including *Continental Bank of Canada v. R.*,[14] *Hickman Motors*,[15] *Neuman*,[16] and *Duha Printers*,[17] were heard and overturned by the SCC on the basis that each of these decisions involved *bona fide* legal transactions, regardless of how unrealistic the series of transactions was. In each of these cases, the SCC avoided making any reference to *Bronfman Trust* or the economic realities doctrine.

Perhaps realizing that the lower courts were going to continue to consider the economic realities of a transaction or arrangement until specifically told otherwise, the SCC in *Shell* took it upon itself to put an end to the economic realities doctrine. The SCC in *Shell* paid lip service to the importance of economic realities in evaluating a transaction, but went ahead and stated that "this Court has never held that economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships".[18]

Post-*Shell* — The New Economic Realities Doctrine

It has become clear in the cases decided after *Shell* that the economic realities doctrine is dead and that the *Shell* principles prevail.[19] Even the Canada Revenue Agency ("CRA") has, to some degree, accepted the application of the *Shell* principles. In *Income Tax Technical News* No. 21,[20] the CRA cancelled IT-233R, citing *Shell* as authority that the economic realities of a transaction or arrangement cannot be used to recharacterize a taxpayer's *bona fide* legal relationships. In *Income Tax Technical News* No. 21, the CRA explained that subject to the general anti-avoidance rule ("GAAR"), "recharacterization is permissible only if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect".

In 2005, the SCC issued its decision in *Canada Trustco Mortgage Co. v. Canada*,[21] the first GAAR case. The Court considered the application of certain language in the Explanatory Notes, which state that the provisions of the Act are intended to apply to transactions with real economic substance, to section 245. On this point, the SCC explained that the GAAR would not apply simply because an economic or commercial purpose was not evident.[22] The Court explained that while open to different interpretations, this requirement will be met where the transaction has been executed "within the object, spirit and purpose of the provisions that are relied upon for the tax benefit".[23] In taking this position, it appears as though the SCC intended to limit the scope of the economic substance language used in the Explanatory Notes. Since *Canada Trustco, supra*, there has been little discussion of the application of economic substance.[24]

Citing *Canada Trustco*, the FCA in *Global Equity, supra,* stated that in order for a loss to be deductible under sections 3, 4, 9, and 11 of the Act, there must be, at the very least, an air of economic or business reality associated with that loss.[25] That Court explained that the fundamental rationale underlying those provisions is that, in order to be used for taxation purposes, business losses must be grounded in some form of economic or business reality.[26] Since no guidance has ever been given by the SCC regarding the application of the economic substance doctrine in *Canada Trustco,* it is surprising that the FCA offered no guidance as to how it arrived at this conclusion. It is unclear from the FCA's decision

where the provisions at issue derive such an economic reality requirement, and, in any event, such approach runs contrary to the *Shell* principles discussed herein. By refusing to hear the taxpayer's appeal in *Global Equity,* the SCC is again sending mixed signals to the lower courts regarding when they must consider the economic realities of a transaction or arrangement and what factors should be considered when doing so.

Conclusion

The doctrine of form over substance is well established in Canada. The SCC's decision in *Shell* now forms part of the fabric of tax law in Canada, having been cited in over 120 cases. In fact, outside of *Tennant, supra,* the economic realities doctrine has never been applied by the SCC. There is little question that the economic realities doctrine, as originally introduced in *Bronfman Trust,* is no longer relevant.

What is not clear is whether an economic substance test has any relevance and, if so, how it is to be applied. While the SCC in *Canada Trustco* appears to have done its best to limit the application of an economic substance test, the FCA in *Global Equity* appears to have ignored such limitations in trying to impart an economic realities test into the GAAR. In light of the decision in *Global Equity,* it is possible that the courts will take the SCC's silence on this matter as authorization for courts below to consider the economic realities of the transactions under review. Conversely, perhaps *Global Equity* will prove to be an anomaly arising uniquely in the GAAR context. Only time will tell how *Global Equity* is received by lower courts on a going forward basis.

A number of tax lawyers from Dentons Canada LLP write commentary for CCH's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for CCH's Canadian* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for CCH's* Federal Tax Practice *reporter and the summaries for CCH's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by CCH:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy Under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Denton's Canada LLP and a member of the Editorial Board of CCH's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

For more insight from the tax practitioners at Dentons Canada LLP on the latest developments in tax litigation, visit the firm's Tax Litigation blog at http://www.canadiantaxlitigation.com/.

Notes:

[1] 2013 DTC 5007.

[2] 99 DTC 5669 (SCC).

[3] At paragraph 39.

[4] Sections 16 and 76 of the Act both apply "notwithstanding the form or legal effect" of the transaction or arrangement, and therefore appear to authorize a review of the economic realities of the transaction or arrangement.

[5] *Shell, supra*, at paragraphs 44 and 45.

[6] [1936] AC 1 (HL).

[7] See *Shell, supra*, for example, at paragraph 44, or *Singleton v. Canada*, 2001 DTC 5533 (SCC), at paragraph 28.

[8] See *Stubart Investments v. R.*, 84 DTC 6305 (SCC), at paragraph 71; *Hickman Motors Ltd. v. The Queen*, 97 DTC 5363 (SCC), at paragraph 8; *Neuman v. The Queen*, 98 DTC 6297 (SCC), at paragraphs 59 and 63; and *Duha Printers (Western) Ltd. v. R.*, 98 DTC 6334 (SCC), at paragraphs 86 and 87.

[9] Sections 16 and 76 of the Act both apply "notwithstanding the form or legal effect" of the transaction or arrangement, and therefore appear to authorize a review of the economic realities of the transaction or arrangement.

[10] See, for example, *Stubart Investments Ltd. v. R.*, 84 DTC 6305, where the SCC discussed the relevance of a "business purpose" test.

[11] 87 DTC 5059 (SCC).

[12] *Ibid.*, at paragraph 49.

[13] 96 DTC 6121 (SCC), at paragraphs 26 and 27.

[14] 98 DTC 6505 (SCC).

[15] *Supra* note 8.

[16] *Supra* note 8.

[17] *Supra* note 8.

[18] At paragraph 39.

[19] See, for example, *Singleton, supra*, note 7 at paragraphs 27 and 31 and *Will-Kare Paving & Contracting Ltd. v. Canada*, 2000 DTC 6479 (SCC), at paragraph 34.

[20] June 14, 2001 [Cancelled].

[21] 2005 DTC 5523 (SCC), at paragraph 56.

[22] *Ibid.*, at paragraph 57.

[23] *Ibid.*, at paragraph 56.

[24] The only reference to economic substance can be found in *Lipson v. Canada*, 2009 DTC 5015 (SCC), at paragraph 38, where that Court explained that

economic substance was relevant under subsection 245(4) only to the extent that the transaction frustrates the purpose of the relevant provisions.

[25] *Global Equity* at paragraph 63.

[26] *Ibid.*, at paragraph 62.

DEPARTMENT OF FINANCE INVITES COMMENTS ON DRAFT LEGISLATION RE BUDGET 2013 MEASURES

On September 13, 2013 (the "announcement date"), the Department of Finance's Tax Policy Branch announced it was inviting comments on draft legislative proposals to amend the *Income Tax Act* and *Excise Tax Act* pursuant to proposals contained in the 2013 Budget. Subscribers to the *Canadian Tax Reporter* (print, DVD, or online) will receive a copy of CCH Special Report No. 074H, which contains the draft legislative proposals and Explanatory Notes. Additional copies of the Special Report may be ordered by calling (416) 224-2248 (toll-free 1-800-268-4522), by faxing (416) 224-2243 (toll-free 1-800-461-4131), or by emailing cservice@cch.ca.

International and business income tax measures proposed include extending the reassessment period of unfiled or improperly filed Form T1135, *Foreign Income Verification Statements*, further extending Canada's thin capitalization rules to Canadian-resident trust and non-resident trust entities, and imposing penalties in instances of incomplete or inaccurate scientific research and experimental development claim forms. The proposals also eliminate leveraged life insurance arrangements' unintended tax benefits and enhance corporate anti-loss trading rules to prevent their circumvention. As well, the proposals adjust the additional deduction of credit unions (already slated to be phased out over five years), enhance the restricted farm loss deduction limit, and clarify restricted farm loss rules. While the proposals reduce the deduction rate for pre-production mine development expenses and phase out accelerated capital cost allowance ("CCA") for capital assets used in new mines and certain mine expansions, the proposals expand eligibility for accelerated CCA in respect of clean energy generation equipment.

Other business and personal income tax legislative proposals include measures to prevent usage of derivative transactions to convert the character of income received, measures to prevent synthetic dispositions where legal ownership of property is still retained, and measures to prevent the inappropriate transfer of trust tax attributes among persons and entities. In addition to the reassessment period for tax avoidance and tax shelter transactions where information returns are filed late or improperly, the legislative proposals also contain measures to phase out the labour-sponsored venture capital corporations tax credit and to streamline the process for pension administrators to correct reasonable registered pension plan errors. The legislative proposals also seek to increase the lifetime capital gains exemption to $800,000 and index the new limit to inflation.

This request for comment is in conjunction with Finance Canada's release of Explanatory Notes to the draft legislative proposals. The closing date for comment on the draft legislation is October 15, 2013 and input can be submitted via email to EAP-PAE2013.tax-fiscalite@fin.gc.ca, by fax to 613-992-2036, or in writing to Tax Policy Branch, Department of Finance, 140 O'Connor Street, Ottawa, Canada, K1A 0G5.

PARLIAMENT IS PROROGUED

On Friday, September 13, 2013, the Governor General prorogued the first session of the 41st Parliament. The Second Session of Parliament is to be opened with the reading of the Speech from the Throne on October 16, 2013.

RECENT CASES

Taxpayer did not retain meaningful books and records to allow deductions but conditions to apply gross negligence penalties not met

The taxpayer was the sole officer, shareholder, and director of an aluminium door and window installation business ("Alco"). The business operated largely on a cash basis. The Minister reassessed the taxpayer by way of arbitrary assessment until returns were filed, after which new assessments were issued for 2004, 2005, and 2006 where there were shareholder benefits of $28,791, $32,173, and $23,351, respectively. Gross negligent penalties were also imposed for each of the three years. The taxpayer argued that he was owed money by the corporation relating to advances and cash amounts paid for rent that were not accounted for.

The taxpayer's appeal was allowed in part. The taxpayer did not maintain meaningful books and records except for rental expense amounts, which were documented, and an agreement was in place. Also, the years at issue were not statute-barred because of misrepresentations due to lack of completeness of returns and were properly assessed by the Minister. Gross negligence penalties, however, did not apply as a result of advertent acts or deceit, deliberate omissions, or culpable intention on the part of the taxpayer.

¶48,497, *Rui De Couto C/O Alco Windows Inc.*, 2013 DTC 1161

Taxpayer's cost in partially reimbursing employer for pilot training program not deductible

The taxpayer was promoted to the rank of pilot in command of a BAE JetStream 32 aircraft. His employer sent him for simulator training on a course costing $12,000, for which his employer paid. The taxpayer then left his employer within 24 months, and he was contractually bound to pay $9,000 to compensate the employer for the cost of finding a replacement pilot. On reassessment, the Minister refused to permit the taxpayer's deduction of this $9,000 in computing his income for 2010. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. Subparagraph 8(1)(*i*)(iii) permits an employee to deduct "the cost of supplies that were consumed directly in the performance of the duties of . . ." an office or employment. The word "supplies" in this context is not defined in the *Income Tax Act*, but in the *Excise Tax Act* a "supply" is defined to mean the delivery of a good or service. Supplies for purposes of subparagraph 8(1)(*i*)(iii) of the *Income Tax Act*, therefore, must, by analogy, include only tangible material that is consumed by the employee in the course of his or her employment. The taxpayer's training program was not a tangible material object. Therefore, it did not fall within the purview of subparagraph 8(1)(*i*)(iii), so that the $9,000 the taxpayer paid towards its cost was not deductible. The Minister's reassessment was affirmed accordingly.

¶48,498, *Auclair*, 2013 DTC 1162

Minister ordered to recalculate tax on taxpayers' shares of father's RRIF received on his death

The taxpayers' father, F, died intestate owing tax, and his only assets were used to pay his funeral and burial costs. F, however, left each of his two children, the taxpayers, one-half of his registered retirement income fund ("RRIF"), together with one-half of a non-registered freedom fund segregated fund investment, which was a hybrid fund. Relying on subsections 160(1) and 160.2(2), the Minister imposed tax vicariously on each of the taxpayers as transferees of their shares of the RRIF and the hybrid fund. The taxpayers appealed to the Tax Court of Canada.

The taxpayers' appeals were allowed. In a prior decision, the Tax Court concluded that the proper way to tax RRIF recipients vicariously on amounts received from a deceased who owes tax is to prepare a two-step tax calculation. First, the deceased's tax owing is calculated normally, including the RRIF benefits. Secondly, the same tax is recalculated, but this time omitting any benefit included under subsection 146.3(6). The difference between the two calculations represents the amount for which both the estate and the RRIF transferee are jointly liable under subsection 160.2(2). The Minister should therefore be ordered to recalculate the subsection 160.2(2) benefit in this case using that methodology. The hybrid fund amount, however, represented benefits from a life insurance policy, which was the predominant component, as well as from a regular investment, and not from a registered retirement savings plan or a RRIF as the Minister had assumed. Therefore, the deceased's interest in this hybrid account was by way of life insurance or some other interest that was transitory. It was also impossible to quantify and did not form part of the deceased's estate property. The Minister's subsection 160(1) assessment with respect to that interest was therefore unsupportable and had to be vacated.

¶48,499, *Higgins*, 2013 DTC 1163

Amounts owing to taxpayer's two corporations but appropriated by taxpayer constituted shareholder's benefits in taxpayer's hands

The taxpayer was the sole shareholder and director of two corporations. The taxpayer personally invested $70,000 in a Bahamian corporation, Commodore, and his two corporations also invested amounts totalling $175,000. Commodore

therefore held investments belonging to the taxpayer and his companies totalling $245,000. During 2004, a corporation known as "Speedo" paid the taxpayer $240,000 on account of the $245,000 invested in Commodore. The taxpayer deposited this $240,000 in his personal account and later transferred it to an investment account with Nesbitt Burns in his own name. At no point did any portion of the $240,000 find its way back into the hands of the taxpayer's two corporations. The Minister included $175,000 of the $240,000 in issue in the taxpayer's income for 2004 as a shareholder's benefit under subsection 15(1) of the *Income Tax Act* and imposed penalties for gross negligence under subsection 163(2). The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. The taxpayer's corporations clearly intended to confer a benefit on him of $175,000, which represented virtually all of their assets. This enabled the taxpayer to wind up those corporations without having to pay tax on any corporate distributions. This series of transactions, moreover, was no oversight on the taxpayer's part. Therefore, his failure to report the $175,000 as income was both knowing and deliberate, which justified the imposition of the penalties. The Minister's assessment was affirmed accordingly.

¶48,500, *Carrier*, 2013 DTC 1164

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