The Supreme Court's 2012 Tax Cases: Formalism Trumps Pragmatism and Good Sense

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I. A Failure of Leadership

Unfortunately, the work of the Supreme Court in interpreting the Income Tax Act or other tax legislation has not often been reviewed in the Supreme Court Law Review. Although the Supreme Court chooses to hear only a few tax cases a year, the Court’s decisions have a profound effect on tax law and the ability of the income tax system to achieve its objectives. The cases the Court hears raise important issues of substantive tax law and the approach the Supreme Court takes in deciding these cases determines how the lower courts approach and resolve the hundreds of cases they hear each year. These cases, in turn, influence how the Canada Revenue Agency (“CRA”) administers tax legislation more generally and how taxpayers plan their affairs. Put another way, how the Court determines tax cases influences the success or failure of tax law in achieving its objectives.

To reveal our position fully at the outset, we take the position that over the years the Court has done a disservice to the aspirations of our tax system in its interpretation of the Act and other tax legislation. There is little question, in our view, that the Canadian income tax system is less fair, more distortionary, more complex and more incoherent than it ought to be because of the Court’s tax decisions and because of the approach it
has taken to tax cases. One of the most astute observers of the Supreme Court’s tax work, Brian Arnold, notes, “in sharp contrast to the judicial activism it displays in other areas of the law, the Supreme Court is unwilling to play a serious role in the tax system”. This observation might be considered something of an understatement.

Tax law is one of the government’s most important policy instruments. It is used by the government to ensure that the costs of government programs are shared equitably across the entire population that benefits from them. Thus, tax law ensures the social acceptability of citizens discharging their moral obligations to one another through government provision of collective goods and services, which is done more equitably and efficiently than if those same goods and services were provided through private markets. The government also uses the tax system to achieve a more morally and socially acceptable distribution of income than that which results from market forces alone. Finally, by indirectly changing the price of particular goods and services through tax penalties, the government uses the tax system to discourage taxpayers from engaging in activities that impose social costs, and, through tax concessions, to encourage taxpayers to engage in activities that provide public benefits.

Tax law is, of course, entirely statutory. There is no common law doctrine requiring citizens to share part of their earnings with others through government. As most people are aware, the Act is a frightfully complicated statute. In consolidation it runs well over 1,500 pages and the annual amendments exceed the size of most statutes. For the Act to be imposed fairly on taxpayers it must describe the tax consequences of almost every form of economic intercourse, from simple barter transactions to the most complicated international corporate reorganizations. Moreover, the Act contains well over 100 implicit spending programs designed to further particular government public policy objectives that have nothing to do with administering a tax system fairly, neutrally and simply.

Even though it is highly detailed, like all statutes, the Act is full of ambiguities, gaps and conflicts. How could it be otherwise? It is drafted by a relatively small and rotating group of drafters, many of whom are comparatively junior. In their work, most have time to become specialists only in small areas of tax law. But even if they were the most senior and

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3 Canada, Department of Finance, Tax Expenditures and Evaluations (Ottawa: Department of Finance, 2012).
skilled drafters it would be impossible for them to anticipate the myriad
circumstances to which their drafted provisions must apply. Moreover,
they are confronted by a much larger group of highly paid lawyers and
accountants whose job it is, in part, to abuse the tax statute for the benefit
of their clients. Hence, in the tax law-making process there is a crucially
important role for the courts. By engaging in and encouraging a most
arid legal formalism when dealing with tax cases, the Supreme Court has
made it almost impossible for the others involved in the tax law-making
process to compensate for its uninspired performance.

Over the past 30 years or so, the Court has repeatedly demonstrated
that it has no sensible or coherent theory of how to interpret tax legisla-
tion. Participants in a lively academic discussion have thoroughly
analyzed and debated the approach the Court appears to have taken to tax
cases. The conventional thought is that, up until the early 1980s, the
Court took a literal and strict approach. In a well-known 1984 case, Stu-
bart Investments Ltd. v. Canada, the Court called for the adoption of the
so-called modern rule of interpretation in tax cases, although the Court
did not apply it in that case (indeed, the holding of the case is that Cana-
dian courts cannot use the business purpose test to assist in minimizing
tax avoidance). The modern rule of statutory interpretation that the Court
adopted was stated by Elmer Driedger in his well-known text on the
Construction of Statutes: “[T]he words of an Act are to be read in their
entire context and in their grammatical and ordinary sense harmoniously
with the scheme of the Act, the object of the Act, and the intention of
Parliament”. Over the next decade, the Court was somewhat erratic in its
application of the modern approach, and in 1994 it began, once again,
deliberately and explicitly to apply the plain meaning approach exclu-
sively. The consequences of this approach have been restated in
numerous cases; however, the most frequently quoted is perhaps
McLachlin J.’s statement in Shell Canada Ltd. v. Canada:

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4 See, e.g., Brian Arnold, “Reflections on the Relationship Between Statutory
Interpretation and Tax Avoidance” (2001) 49:1 Can. Tax J. 1; David Duff, “Justice Iacobucci and
the ‘Golden and Straight Metwand’ of Canadian Tax Law” (2007) 57 U.T.L.J. 525; David Duff,
47:4 Can. Tax J. 741; Jinyan Li & David Piccolo, “Reviving the Modern Rule in the Interpretation of
Tax Statutes: Baby Steps Taken in Canada Trustco, Mathew, Placer Dome and Imperial Oil” (2007)
38 S.C.L.R. (2d) 519 [hereinafter “Li & Piccolo”].


[I]t is well established in this Court’s tax jurisprudence that a searching inquiry for … the general object and spirit of the provision at issue can never supplant a court’s duty to apply an unambiguous provision of the Act to a taxpayer’s transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied … .

Then, in 2005, in Canada Trustco Mortgage Co. v. Canada, the first case before the Court that involved the application of the general anti-avoidance rule (“GAAR”), the Court once again stated that the appropriate approach to statutory interpretation, even in tax cases, was the “textual, contextual, and purposive” approach. In “Reviving the Modern Rule in the Interpretation of Tax Statutes: Baby Steps Taken in Canada Trustco, Mathew, Placer Dome and Imperial Oil”, Jinyan Li and David Piccolo examined four cases decided in 2005 and 2006, and optimistically predicted that the Court was jettisoning the plain meaning approach and moving forward with applying the modern approach. They urged the Court to continue along this path and to “assume a more active role in tax law-making through interpretation”.

Unfortunately, the authors’ optimism was misplaced. Even in the case in which they proposed the textual, contextual and purposive approach, the Supreme Court stated that, “[T]he Income Tax Act remains an instrument dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation”. In subsequent cases, the Court returned to the plain meaning approach with a vengeance. Seldom do the Supreme Court justices search for the purposes of the tax sections they are interpreting. They almost never consider the consequences of their decisions in terms of the familiar tax principles of equity, neutrality and simplicity. And they usually do not consider, at least explicitly, whether their decision reaches a sensible or an absurd result.

Why the Court clings so tenaciously to the plain meaning approach in tax cases is not obvious. Perhaps it distrusts the legislative process and this is a way of not giving effect to the objectives of Parliament. Or maybe it is concerned about its own ability to discern the purpose of tax

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10. Li & Piccolo, supra, note 4.
11. Id., at 556.
provisions or weigh the consequences of alternative interpretations in terms of tax principles. The plain meaning approach appears to simplify the decision-making process. It involves ascribing a meaning to words and deducing an answer to their application on a specific set of facts. It allows the Court to escape responsibility for the outcomes of its decisions. The results are thought to be preordained by the words the drafters chose. The justices of the Supreme Court have suggested in several cases that their approach to statutory interpretation in tax cases leads to greater certainty and predictability in the application of the tax law.

Whatever the Court’s reasons for taking a formalistic, plain meaning approach in tax cases, it is profoundly wrong. Words do not have plain meanings. Determining the appropriate usages of words, any words, depends upon examining the context in which they are used. When a word is used in a statute, that context always includes what the legislative body was attempting to achieve in passing the statute. Moreover, with respect to tax law, it is universally agreed upon that the purpose should be achieved in a way that is equitable, neutral and administratively practicable. Thus, instead of a plain meaning approach, the Supreme Court should adopt a consequentialist or pragmatic approach to interpreting tax legislation, recognize that its responsibility is to play a complementary role to the legislature in furthering the objectives of the law, and acknowledge explicitly its important and inevitable law-making role. In short, the responsibility of judges is to reach a sensible policy result after considering the consequences of alternative interpretations.

This is not the place to engage in an extended discussion of the definition of the formalist approach taken by the Supreme Court and what a more pragmatic and consequentialist approach would look like. Elsewhere, one of us has argued that approaches to statutory interpretation other than pragmatism are incoherent, and that if judges relied more on a consequentialist approach, it would “strengthen judgments; make results more accessible, predictable and objective; increase the efficiency of the litigation process; allow for the improvement of legislative drafting; increase the justice, neutrality and simplicity of the tax system; and more fully employ the unique skills and institutional competence of judges”.

Justice Donald Bowman was a judge of the Tax Court of Canada from 1991 to 2005 and Chief Justice from 2005 to 2008. He is widely regarded as one of the most distinguished tax judges in Canadian history. In a tribute to him upon his retirement we compared the generally pragmatic approach he took in resolving tax cases with the more formalistic approach taken by the Supreme Court justices.\textsuperscript{14} We noted that while the Supreme Court justices relied on a formalistic approach and appeared to think they could resolve complicated tax cases simply by ascribing plain meanings to words, Bowman C.J.’s approach was more thoughtful and appropriate:

> He recognized that pragmatic adjudication is unavoidable and that deciding cases involves problem-solving skills of the highest order. He did not purport to deduce answers to complex cases based on the supposed plain meaning of words or phrases. He stated goals, weighed consequences, and chose appropriate results based on notions of policy, common sense, professional values, and sensitivity to relevant tax principles … . He always tried hard to reach the best results as he understood them.\textsuperscript{15}

Obviously, the justices did not read our earlier article, or if they did they were not persuaded by it or by what we regarded as the genius of the approach to statutory interpretation generally taken by Bowman C.J.

In 2012 the Supreme Court only heard a handful of tax cases. And as the following four case summaries illustrate, the Court still holds doggedly to a formalistic approach. They have refused to take seriously the purposes of the provisions they are interpreting, the consequences of their decisions in terms of tax principles, or the most sensible and appropriate result among the alternative interpretations that were open to them.

In \textit{Canada v. Craig},\textsuperscript{16} the Supreme Court reached a result that effectively read a long-standing section out of the Act, even though the section reflects both sound tax policy principles and important tax expenditure considerations. Moreover, they did it by overruling a judgment that a unanimous Supreme Court panel had handed down over 35 years earlier — a judgment that made sense out of the provision, had been administered appropriately by the CRA over the

\begin{footnotes}
\item[15] \textit{Id.}, at 27.
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subsequent years, and was sanctioned in various ways by the Executive (and by Parliament, in that there was never any parliamentary suggestion over the past 35 years that the earlier case had misconstrued the meaning of the provision). The Supreme Court reached this perverse result in the case (nullifying an important statutory provision) simply on the grounds that the earlier Supreme Court panel had not followed the plain meaning of the words in the section. Since this case so clearly reflects the staggering failure of the Court’s formalism, we discuss it in some detail.

*Fundy Settlement v. Canada*\(^{17}\) presented the Court with the need to formulate a test to determine the residency of trusts for tax purposes. Instead of assuming the role of pragmatic tax policy analysts and formulating a residency test that would preserve the purpose that residency requirements serve in an income tax system by, for example, making tax avoidance more difficult, the Court resolved the issue formally by resorting to an argument by analogy with corporations.

In *Canada v. GlaxoSmithKline Inc.*,\(^{18}\) the Court dealt with a case in which Rip A.C.J. of the Tax Court of Canada (as he then was), after an exhaustive review of the evidence, held a multinational to have engaged in egregious tax avoidance through the manipulation of transfer prices. In sending the matter back to the trial court for a redetermination of the reasonableness of the taxpayer’s transfer prices, the Court imposed a test of reasonableness that will make it even easier for multinationals to manipulate their transfer prices to avoid tax.

*Calgary (City) v. Canada*\(^{19}\) does not illustrate the Court’s formalism in approaching tax cases since the case did not raise any interpretive issue. It involved the application of reasonably well-understood consumption tax concepts under the Goods and Services Tax (“GST”). The Supreme Court did not significantly advance the prevailing understanding of how these concepts should be applied, but at least it did not further confuse the issues. One wonders why they granted leave to appeal in the case.


II. Canada v. Craig: A Failure of the Judicial Process

This case raises a specific but nevertheless significant tax policy issue. But, more importantly, this case raises the critical matter of how the Supreme Court does and should approach issues of statutory interpretation. Moreover, it provides a fascinating window into how the lower courts deal with Supreme Court decisions that make them uneasy.

1. The Issue

The specific tax issue in the case relates to the circumstances under which a taxpayer can offset losses incurred in a farming business against income earned from a completely different source of income, such as a law practice. Normally, since the whole point of an income tax is to tax taxpayers on their annual net income (as a reflection of their ability to pay), losses from any source of income should be allowed to be, and normally can be, offset against gains from any other source of income. However, a somewhat notorious provision in the Act — section 31 (commonly referred to as the “restricted farm loss rule”, but most tax lawyers would be familiar with the section number) — limits the deductibility of farming losses against other income in certain circumstances.

Basically, section 31 restricts the deduction of farm losses against income from another source unless the taxpayer falls within one of two exceptions: (1) farming is the taxpayer’s chief source of income (the chief source exception); or (2) a combination of farming and some other source of income is the taxpayer’s chief source of income (the combination exception). To appreciate the interpretive issue, the precise wording of section 31 is important: “Where a taxpayer’s chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income … [then the taxpayer’s loss] if any, for the year from all farming businesses carried on by the taxpayer shall be deemed to be … [no more than $8,750].”

Clearly, the section restricts the amount that a taxpayer with a farming loss can deduct from other sources of income in some circumstances.

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The restricted farm loss rule limits the deduction of farm losses to a maximum of $8,750 annually: $2,500 plus half of the next $12,500. Farm losses in excess of that limited amount can be carried back three years and forward for 20 years to be claimed against farming income (supra, note 1, s. 111(1)(c)). The Conservative government proposed to increase the limit to $17,500 in their 2013 budget: Restricted Farm Losses, online: Canada Revenue Agency <http://www.cra-arc.gc.ca/gncy/bdgt/2013/q409-eng.html>.
But what precisely is the effect of the section? Over the past 60 years this question has been litigated often. The issue arises frequently since everyone who operates a farm and also has some other source of income is potentially affected by the section. The facts in *Craig* raise one of the trickier interpretive problems posed by the section.

In *Craig*, the taxpayer carried on a successful law practice and at the same time operated a horse farm in which he frequently realized large losses. In 2000 and 2001, the two years for which he was reassessed, he reported earnings from his law practice of $770,423 and $646,600 respectively. In those two years, he reported losses from his horse farm of $222,642 and $205,655 respectively. In both years, he deducted the farm losses from his law practice earnings. The CRA invoked section 31 and reassessed, limiting the farm losses the taxpayer could deduct from his law practice earnings to $8,750 each year.

In support of the unlimited offset of his farming losses, the taxpayer argued that section 31 posits two tests for determining whether the deductibility of farm losses should be restricted: it applies if a taxpayer’s “chief source of income” is neither (1) “farming” nor (2) “a combination of farming and some other source of income”. He conceded that his chief source of income was not farming but argued that it was a combination of farming and a law practice, and therefore under the latter combination test his farm losses should not be restricted. The interpretive issue in the case is thus a simple one: what does the phrase as used in the section, “a combination of farming and some other source of income”, mean? The problem is that to give this phrase almost any meaning makes it hard to make sense out of the section. Before looking at how the Supreme Court dealt with this issue in *Craig*, a bit of judicial history provides some important context.

The section in its modern form was enacted in 1952. For the next 25 years the predecessors to the Tax Court of Canada struggled with its interpretation.

As a slight digression, one interpretive problem the courts struggled with was the meaning of the phrase, “a taxpayer’s chief source of income for a taxation year”. If this phrase is given its common usage the whole section becomes nonsense. Again, the section provides, “[w]here a taxpayer’s chief source of income for a taxation year is … farming … the taxpayer’s loss, if any, for the year from all farming business carried on by the taxpayer shall be deemed to be [not more than $8,750].” But how can a taxpayer’s “chief source of income for a taxation year” be one in which he or she incurred a loss? As a matter of ordinary usage it would
be odd if someone who had two businesses, one in which they incurred a profit, and one in which they incurred a loss, reported that the business in which they incurred a loss was their chief source of income for that year (it might be said to be their chief source of income over a longer period but the section refers to the taxpayer’s chief source of income for the taxation year). In ordinary usage we do not often equate a loss with a source of income, let alone a chief source of income. In the Act, the concept of income is generally used to refer to a positive amount.

A number of cases did indeed hold that a business in which a taxpayer realized a loss could never be his or her chief source of income, and thus essentially restricted the deduction of all farm losses. However, other cases solved this problem by giving a meaning to the term “chief source of income” that made sense out of the provision. They held that a taxpayer’s chief source of income in a year did not actually require the taxpayer to realize any income from that source in that year. The taxpayer’s “chief source of income” was the source of income in which they had invested most of their capital, devoted most of their time, and had an expectation of long-term profits, basically the source of income that the taxpayer would regard as his or her major occupation over a longer period of time.\(^1\) Hence, to take an easy case, if a taxpayer had lived on a farm all of his life, had farm expertise, operated the farm as a business, had substantial investments in the farm and devoted most of his time to operating the farm, the farm would be his chief source of income in a year even if he had realized a loss on the farm and had another part-time construction or other job with income that he could use to offset the farm loss.

It bears noting that the Supreme Court accepted this meaning of “chief source of income” in \textit{Craig} even though in interpreting the phrase, “a combination of farming and some other source of income”, it refused to look beyond what it regarded as the plain meaning of the words.

As mentioned, the interpretive issue in \textit{Craig} was the meaning of the phrase, “a combination of farming and some other source of income”. There are three obvious ways the phrase might be interpreted. First, it might be read as meaning that, in arriving at a taxpayer’s chief source of income, the farming income (or loss) can be combined with any other

\footnote{\textit{See Moldowan v. Canada}, [1977] S.C.J. No. 55, [1978] 1 S.C.R. 480, at 485 (S.C.C.) [hereinafter \textit{Moldowan}]: “On a literal reading of the section, no taxpayer could ever claim more than the maximum $5,000 deduction which the section contemplates; the only way in which the section can have meaning is to place emphasis on the words “source of income.””}
source of income the taxpayer might have. Thus, if the taxpayer is both farming and practising law, his or her chief source of income is a combination of these two sources. The obvious difficulty with this interpretation is that it appears to make nonsense out of the section itself. In almost every case taxpayers would be able to deduct their farming losses against their other income. Second, the phrase might be read as meaning that the source of income that is combined with farming has to be related to farming in some way; that is to say, the two sources have to be connected. The difficulty with this interpretation is that there are no specific words in the phrase suggesting that the two sources of income have to be connected. Third, the phrase could essentially be ignored and hence, unless a taxpayer’s chief source of income is farming, the farm loss would be restricted under the provision. This interpretation makes sense out of the provision but the difficulty with this interpretation is that the courts are reluctant not to give a meaning to every word and phrase used in a statutory provision.

2. **Prior Judicial History: Moldowan v. Canada**

From the mid-1950s until the mid-1970s, cases in the tax administrative tribunals and trial courts had taken each of these three approaches; however, the CRA was administering the section on the basis that unless farming was the taxpayer’s chief source of income, his or her farming losses were restricted (the third possible interpretation above). In 1973, the meaning of this phrase was raised in a case that was eventually appealed all the way to the Supreme Court, *Moldowan v. Canada.* In that case, the taxpayer operated a horse racing business in which he incurred large losses in most years. He offset these losses against income from another business. The Minister allowed only the restricted deduction under section 31. The taxpayer’s appeals to the Tax Review Board and then the Trial Division of the Federal Court were both dismissed without any discussion of the combination test but simply on the grounds that farming was not the taxpayer’s chief source of income.

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22 *Id.*
The Federal Court of Appeal[^25] upheld the decision of the Trial Division, but each of the three judges gave separate reasons and one dissented. Justice Pratte dealt directly with the meaning of the phrase, “combination of farming and some other source of income”. He said that he did not share the view that a taxpayer’s chief source of income could be a combination of farming and some other source even if there was no connection of any sort between the farming activities and other sources of income. In his opinion, “combination” meant more than “addition”, and it implied “a certain degree of association or integration”.[^26] Only if two sources of income were in some way integrated or interconnected could it be said that their combination constituted one source of income. Moreover, if “combination” meant nothing more than “addition”, section 13 (now section 31) would be devoid of any effect, “since the taxpayer engaged in the business of farming ... could always claim (by adding ‘farming’ to his most important source of income) his chief source of income to be a ‘combination of farming and some other source of income’”.[^27]

In his dissent, Urie J. took issue with this view, stating that to imply that there must be a connection between things which are combined would require that additional words be read into the section, “and would strain the natural meaning to be given to a word”.[^28] He went on to say that if a person carrying on the business of farming had only one other source of income he was obviously outside the purview of subsection 13(1).[^29] Thus, on Urie J.’s reading, the section applied only if the taxpayer had more than two sources of income, and farming could not be combined with one of them to constitute his chief source of income. While concentrating on the apparent plain meaning of the words, Urie J. appears unaware of what a strange result he reached. What could be the possible justification for restricting a taxpayer’s farm losses if they have three sources of income, but not if they only have two? Arguably, this is the effective result of the Supreme Court’s decision in Craig[^30].

The Supreme Court of Canada dismissed the taxpayer’s appeal in a relatively short unanimous judgment written by Dickson J. It is unclear from his judgment exactly how the combination test should be applied. He stated that in applying the test, the two sources of income did not

[^26]: Id., at para. 10 (F.C.J.).
[^27]: Id., at para. 11.
[^28]: Id., at para. 19.
[^29]: Id., at para. 33.
have to be connected. But he also stated that, “[I]t is clear that ‘combination’ in s. 13 cannot mean simple addition of two sources of income for any taxpayer. That would lead to the result that a taxpayer could combine his farming loss with his most important other source of income, thereby constituting his chief source. … Such a construction would mean that the limitation of the section would never apply … .”  

He concluded that section 31 applies to “the taxpayer who does not look to farming … for his livelihood but carries on farming as a sideline business”. Although Dickson J.’s judgment might be capable of a different reading, most commentators and judges accepted that it meant that farming had to be the taxpayer’s chief source of income in order to avoid the restriction of section 31. His judgment appeared to give no meaning to the combination test.

3. Prior Judicial History: Gunn v. Canada

Following Moldowan, the CRA continued to apply the section 31 restriction on the deductibility of farming losses to every taxpayer whose chief source of income was not farming. Of course, particularly high-income businesspeople and professionals who operated farms, often horse racing operations, as a sideline business or part-time, continued to complain about the application of the section to them. Also, commentators and some judges noted that the Supreme Court’s interpretation appeared to give no meaning to the combination test.

In 2006, after a number of failed taxpayer efforts to work around Moldowan, a part-time farmer found a sympathetic Federal Court of Appeal panel. Douglas G. Gunn was a lawyer in Southwestern Ontario who maintained a mixed farm operation that included cattle, grains and tobacco. He had invested a considerable sum in the farming operation and spent a lot of time working on it, although not as much time as he did at his law practice. Over the years in question (1997-1999) he reported income from his law practice of between $205,000 and $309,000 and farm losses ranging from $54,000 to $159,000. The CRA restricted the deductibility of the farm losses under section 31. In the Tax Court of Canada, Bowie J. applied Moldowan and held that the taxpayer’s “farming was, in the words of Dickson J., ‘a sideline business’”.  

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30 Moldowan, supra, note 21, at 487 (S.C.R.).
31 Id.
The taxpayer appealed to the Federal Court of Appeal which, in a lengthy, thorough and bold judgment, overturned the Tax Court and basically refused to follow Moldowan.\textsuperscript{33} Since the Supreme Court agreed with the Federal Court of Appeal’s holding, although it held that the Federal Court was wrong in not following Moldowan, we will set out the Federal Court’s reasoning in some detail. Also, Sharlow J.A.’s thorough analysis of the factors to be considered in interpreting a tax provision should be contrasted with the Supreme Court’s sole reliance on the plain meaning of the words. Although Sharlow J.A. attempted to deal seriously with the issues raised, unfortunately she reached the wrong result. She was misled (likely by counsel) about the purpose of the section, its history and the effect of her decision. Moreover, she was constrained by the Supreme Court’s injunctions against lawmaking.

Writing for a unanimous court, Sharlow J.A. begins her judgment by citing the Supreme Court’s judgment in Trustco\textsuperscript{34} and stating that, “[T]he interpretation of section 31 requires a textual, contextual and purposive analysis to find a meaning that is harmonious with the Income Tax Act as a whole, and that achieves consistency, predictability and fairness so that taxpayers may manage their affairs intelligently”. In searching for the meaning of the phrase, “a combination of farming and some other source of income”, Sharlow J.A. examines each factor set out by the Supreme Court in Trustco. First, she examines the statutory context, but finds no assistance;\textsuperscript{35} she next reviews the legislative history of section 31, but again finds no assistance in that history to give meaning to the phrase;\textsuperscript{36} and she then turns to the purpose of section 31 for assistance but concludes, “I have been able to find nothing that provides a satisfactory explanation for the existence of section 31.”\textsuperscript{37}

She then turns to the Supreme Court’s judgment in Moldowan. Highlighting the Supreme Court’s insistence on the desirability of consistency, predictability and fairness in interpreting the Act, she notes that even after Moldowan, the application of the section gave rise to considerable uncertainty. As evidence, she reviewed the five cases that the Federal Court of Appeal had heard over the previous eight years.\textsuperscript{38}

\textsuperscript{34} Supra, note 9.
\textsuperscript{35} Gunn, supra, note 33, at paras. 15-26 (F.C.J.).
\textsuperscript{36} Id., at paras. 27-44.
\textsuperscript{37} Id., at paras. 45-54.
\textsuperscript{38} Id., at paras. 62-69.
She notes that several commentators and judges had criticized *Moldowan* on the grounds that although Dickson J. held that section 31 “should apply to a person for whom farming is a ‘sideline’ business or a ‘subordinate’ source of income … section 31 does not use the words ‘sideline’ or ‘subordinate’, or any analogous term.” 39 Finally, she refers to a number of recent Supreme Court cases where the Court had warned “against the development of judge-made rules in tax matters”, and in particular against reading “unlegislated gloss” into a section that has a “discernable literal meaning”. 40 She concludes that the kind of judicial intervention that Dickson J. had undertaken in *Moldowan* was inconsistent with this more recent approach to statutory interpretation taken by the Supreme Court.

Although adamant that some meaning should be given to the combination test, she was not entirely clear what it should be. She appears to suggest that in order for farming to be combined with some other source of income it is not necessary that farming be the taxpayer’s chief source of income (since that is the first test), only that the farming business be a substantial undertaking. A lengthy quote seems necessary to provide a sense of her holding:

> In my view, the combination question should be interpreted to require only an examination of the cumulative effect of the aggregate of the capital invested in farming and a second source of income, the aggregate of the income derived from farming and a second source of income, and the aggregate of the time spent on farming and on the second source of income, considered in the light of the taxpayer’s ordinary mode of living, farming history, and future intentions and expectations. This would avoid the judge-made test that requires farming to be the predominant element in the combination of farming with the second source of income, which in my view is a test that cannot stand with subsequent jurisprudence. It would result in a positive answer to the combination question if, for example, the taxpayer has invested significant capital in a farming enterprise, the taxpayer spends virtually all of his or her working time on a combination of farming and the other principal income earning activity, and the taxpayer’s day to day activities are a combination of farming and the other income earning activity, in which the time spent in each is significant. 41

39  *Id.*, at para. 70.
40  *Id.*, at paras. 74-77.
41  *Id.*, at para. 83.
This definition is essentially the meaning of the combination test that the Supreme Court adopts. Justice Sharlow does not state explicitly that she is refusing to follow Moldowan, but that is the thrust of her judgment.42

Following Gunn, the Tax Court decisions were in disarray. Some Tax Court judges applied Gunn, while others continued to follow Moldowan. Clearly, a resolution by the Supreme Court was called for.

4. Lower Court Decisions

Three years after Gunn was decided by the Federal Court of Appeal, Mr. Craig brought his case to the Tax Court. It was a typical farm loss case involving a relatively well-to-do taxpayer attempting to offset large losses from a horse racing business against his professional income, and to which the CRA had consistently applied the restriction in section 31. In the Tax Court, Mr. Craig relied heavily on the decision in Gunn to support his position that his horse racing operation, in combination with his law practice, was his chief source of income for the relevant years. The Crown, on the one hand, argued that Mr. Craig’s chief source of income was neither farming nor a combination of farming and some other source, because farming was not his predominant source of income as required by Moldowan. The Crown also argued that the Tax Court of Canada should feel itself bound by the Moldowan decision rather than following the Gunn decision. The taxpayer, on the other hand, urged the Tax Court judge, Hershfield J., not to follow Moldowan on the grounds that interpreting the combination test as requiring the taxpayer’s other source of income (his law practice in this case) to be subordinate to his farming income rendered the test superfluous. He also argued that the principles of statutory construction on which Moldowan was decided were no longer acceptable since the Supreme Court in that case was inappropriately making law. Further, he noted that Moldowan had attracted considerable criticism.43

In deciding in favour of the taxpayer, Hershfield J. applied the combination test articulated in Gunn and held that even if farming was a sideline or subordinate business, section 31 would not apply if farming was a substantial business compared to the taxpayer’s chief source of income. Here is how Hershfield J. put it: “Contrary to Moldowan, Gunn

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42 To hedge her holding, Sharlow J.A. goes on to conclude that in any event, on the facts of the case, she would not find that Mr. Gunn’s farming activities were a mere sideline (id., at para. 92).
suggests that the activity propping up the farming income need not be subordinate to farming but rather it suggests that the farming activity, relative to the other source [of income], must make a relevant or meaningful contribution to the aggregation formula assessed by using the Moldowan criteria. He did not expressly refuse to follow Moldowan but instead he reasoned that, “Gunn simply puts the Moldowan analysis back on track as a workable construction of section 31 — one that does not render it sterile while paying heed to the language of the section”. In not applying the section 31 restriction, he found the facts in Craig to be indistinguishable from the facts in Gunn.

The Minister appealed primarily on the grounds that the trial judge had erred in applying the interpretation of the combination test set out in Gunn as opposed to the one set out in Moldowan. The Federal Court of Appeal dismissed the Minister’s appeal, reasoning that it was bound by its previous decision in Gunn.

5. Supreme Court

On appeal to the Supreme Court of Canada, Rothstein J. first held that both the Tax Court and Federal Court of Appeal erred in not following the combination test as set out in Moldowan. He stated that those courts might have given reasons as to why Moldowan was problematic, but they should have followed it rather than “purporting to overrule it”.

He then addressed directly the question of whether the Supreme Court should overrule its prior decision in Moldowan. He noted a number of cases where the Supreme Court had overruled one of its prior decisions, but cautioned that overruling a prior case should only be done where there were “compelling reasons that the precedent was wrongly decided”. He then gave three reasons that Moldowan should be overruled: (1) the effect of the decision was to “read the combination test out of s. 31(1)”; (2) “there has been significant judicial, academic and other criticism of Moldowan”; and (3) “since Moldowan, this Court has held on a number of occasions that unexpressed legislative intention under the guise of purposive interpretation is to be avoided … . A judge-made rule

44 Id., at para. 57.
45 Id., at para. 61.
48 Id., at para. 25.
that reads one of the exceptions out of the provision is not consistent with the words used by Parliament.”

Agreeing that the combination test should not be given an interpretation that renders the section meaningless, Rothstein J. cites Sharlow J.A.’s judgment in *Gunn*, and other authorities, as support for the proposition that the test “does not contemplate a simple aggregation of two sources of income, but requires a wider inquiry into the amount of capital, time, effort, commitment and general emphasis on the part of the taxpayer with respect to the sources of income”. Thus, although farming does not need to be the predominant source of income in applying the combination test, the taxpayer must “devote significant time and resources to the farming business” in order for the losses to be combined with another source of income under the combination test. He concluded by noting that Hershfield J. had considered the relevant factors at the trial level and stated that there was no basis for disturbing his finding of fact that, under this interpretation, the combination test was satisfied and hence the section 31 loss restriction did not apply.

The Supreme Court’s interpretation of section 31 ignores the purpose of the provision, leads to an untenable policy result, is based on a misreading of the history of the section, and is contrary to the Court’s stated approach to statutory interpretation in that it requires words to be read into the section — that is, it requires lawmaking. This interpretation starkly illustrates the Court’s fixation on the text of a tax provision to the exclusion of the consequences.

### 6. Purpose for Restricting the Deduction of Farm Losses

As an indication of the formality of the Supreme Court’s approach to statutory interpretation in *Craig*, not once in the judgment did Rothstein J. allude to the possible purpose of section 31, the potential consequences of his decision, or the end goal of his interpretation in terms of tax principles. He purported to be able to solve the problem with which the Court was confronted simply by reading the section, divorced from its context. Aside from anything else, this seems contrary to the Court’s oft-stated proposition that it takes a textual, contextual and purposive analysis in interpreting legislation.

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49 *Id.*, at paras. 28-30.
50 *Id.*, at para. 37.
51 *Id.*, at para. 41.
Quite astonishingly, judges in a line of cases interpreting section 31, including Gunn and the lower court judges in Craig, professed to be unaware of the policy reasons for section 31. Based on this, perhaps Rothstein J. thought it would be futile to search for or speculate about the purpose of the section; however, in fact, section 31 plays two important (and if we may say so, quite obvious) roles in the tax system. First, it and sections like it play an important role in increasing the equity of the technical tax system by limiting the deductibility of personal expenses. Second, section 31 serves a crucial role in implementing the policy goals of the tax expenditures for farming in the Act by targeting those tax expenditures primarily on full-time farmers. In light of these important policy objectives, it is little wonder that in the first budget tabled after Craig, the federal government announced it was amending section 31 to override the holding in Craig and to reinstate the combination test as interpreted in Moldowan.52

Since they seem to be so misunderstood, we elaborate slightly on each of these purposes of section 31. The income tax derives its moral legitimacy from the fact that it taxes two people who consume personal goods and services of equivalent value (and who have the same savings) the same. Consequently, one of the most fundamental principles underlying an equitable tax system is that businesspeople should not be able to deduct an expense — even if incurred in order to earn a profit — to the extent that they derive a personal benefit from it. That is why, for example, under the Act, the cost of yachts and memberships in private clubs are not deductible, even though a taxpayer might incur those costs to entertain clients and earn income.53 Even if incurred in a business context, it is assumed that the personal benefit of these expenses equals their cost. Similarly, only 50 per cent of the cost of business meals and entertainment is deductible.54 Although the personal benefits derived from these expenses, even if incurred in a business context, might not equal their cost, they are assumed to be substantial, as reflected in the disallowance of

52 See Annex 2: Tax Measures — Supplementary Information and Notices of Ways and Means Motions, in Canada, Department of Finance, Canadian Federal Budget 2013 (March 21, 2013), at 362, online: <http://www.budget.gc.ca/2013/doc/plan/budget2013-eng.pdf>: “The Moldowan decision is consistent with the purpose of the chief source of income test, which is to ensure that taxpayers for whom farming is not the principal occupation are limited in their ability to deduct farm losses from their non-farm income. . . . Budget 2013 proposes to amend [section 31] . . . to codify the chief source of income test as interpreted in Moldowan.”

53 Income Tax Act, supra, note 1, s. 18(1)(l).

54 Id., s. 67.1.
one-half the expense. Although many other tax policy doctrines could be used to illustrate this point, just one more example will suffice. The expenses of maintaining a home workplace used in a business can only be deducted from income from that business.\textsuperscript{55} The reason for this is that it is assumed that even though home office expenses are incurred to earn income, these expenses are likely to contain a personal element.

Many individuals who pursue farming as a part-time business derive enormous personal satisfaction from the activity even though they might expect to realize a profit at some point (so they are not hobby farmers). These might be people who work in the city but who operate small farms because they enjoy the rural lifestyle, or who enjoy being around and raising animals, or who enjoy breeding or raising racing horses. Indeed, most of the litigated section 31 cases involve horse farms. Being involved in horse racing seems to hold a special fascination for many wealthy individuals. It enables them to admire the grace and beauty of well-trained horses and to engage legitimately in the thrill of gambling and the excitement of having a horse in the race (so to speak). As an indication of the personal enjoyment involved in horse racing, many people spend huge amounts to follow the sport solely as a hobby. It is, after all, the Sport of Kings. Hence, the restriction on the deductibility of losses for part-time farmers is an indirect way of limiting the personal expenses that these taxpayers might otherwise deduct.

The section limits the deductibility of the personal element of business expenses relating to part-time farming but, in addition, the section operates to limit the deductibility of farm expenses incurred solely for a personal purpose. It is often difficult to distinguish between hobby farmers and business farmers. By limiting the deductibility of expenses, section 31 reduces some of the cost of making a mistake along this margin by treating a hobby farmer as carrying on a business. Thus the section takes some pressure off the CRA to classify farmers as hobbyists.\textsuperscript{56}

\textsuperscript{55} Id., s. 18(12)(b).

\textsuperscript{56} See Michael Wilson, \textit{Tax Issues in Agriculture: A Discussion Paper} (Ottawa: Department of Finance, 1985) at 30: “[T]he restricted loss provision creates a middle ground between full-time farmers and those farming without any expectation of profit. As it is not always easy to determine the expectation of profit, the middle ground minimizes the need for a rigid enforcement of this test and the resulting potential disputes between Revenue Canada and taxpayers, especially where the loss amounts are small.”
The other reason that farm tax losses are restricted in section 31 follows from the fact that the Act is filled with tax concessions for farmers. The Department of Finance lists 15 tax concessions for farmers in its annual tax expenditure account.\(^{57}\) For example, farmers are allowed to report their income on a cash basis and to deduct as a current expense land improvement expenses.\(^{58}\) Moreover, tax concessions that in theory apply to all businesses are often of particular significance to farmers, such as the ability to deduct the carrying charges on farm land currently, even though a good deal of the corresponding income will be deferred and taxed as a capital gain when realized. Hence, an important purpose of section 31 is to target the implicit tax spending provisions in the Act on full-time farmers.\(^{59}\) Indeed, without section 31, these tax concessions would in most cases have the perverse effect of being more valuable to part-time farmers with high off-farm income than to full-time farmers who might have no other income to offset them against, or whose income might be taxed at lower marginal rates than that of high-income part-time farmers.\(^{60}\) Among other things, not attempting to target these concessions on full-time farmers would substantially increase their cost and would provide part-time farmers with an unfair competitive advantage over full-time farmers.

The purposes of section 31 should be evident to anyone familiar with tax policy and tax expenditure analysis. But more significantly, the Department of Finance clearly set them out in a discussion paper it released in 1985 on tax issues in agriculture.\(^{61}\) That document contains a 20-page discussion of section 31 and possible reforms to it. It is shocking that this document was not referred to in *Gunn* or *Craig*.

Moreover, going back further, the *Recommendations of the Royal Commission on Taxation* (also known as the “Carter Report”), which

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\(^{58}\) For a description of many of the special tax concessions for farmers and a critical appraisal, see Alex MacNevin, “Agricultural Taxation in Canada: An Overview and Assessment” (1998) 46:2 Canadian Journal of Agricultural Economics 93, at 114: “There is always a natural bias among elected officials and the general public to try to make things easier for farmers through preferential tax rules. However such an approach is often doomed to failure in the long run.”

\(^{59}\) Among other indications, this purpose of s. 31 might be inferred from its place in the Act. Section 28 allows farmers to report their income on a cash basis; s. 30 allows for the current deduction of all expenses of improving land for farming. Section 31 then attempts to target these concessions on full-time farmers.

\(^{60}\) *Supra*, note 56, at 29.

\(^{61}\) *Id.*, at 20-39.
remains in many cases the best source of analysis relating to the tax policy choices underlying the Act, contains a clear description of the problem of both limiting the deductibility of personal expenses of part-time farming operations and of limiting the tax concessions for farmers to full-time farmers. After stating the issues that section 31 (then section 13) was intended to deal with, the Commission ultimately recommended that the section might be repealed but only because the Commission recommended it be replaced by a general provision designed to prohibit the deduction from other income of losses incurred by any business that consistently (over three loss years) operated at a loss. They also recommended that most of the special concessions for farmers be repealed, including the ability to report their income on a cash instead of an accrual basis ("except in the case of an individual whose principal source of income is farming and whose gross revenue from farming is less than a specified sum, say, $10,000").

In the Tax Reform Act of 1972, the government did not adopt the Commission’s recommendation to enact a general loss restriction provision or to abolish cash accounting for farmers; therefore, it retained the rules restricting the deduction of losses for part-time farmers in section 31 of the reformed legislation. Following the Carter Report, the Government’s White Paper on Tax Reform recommended that the farming loss restriction rules be retained, and both the Senate and


63 See Recommendations of the Royal Commission, id., at 136. With respect to the cash basis of accounting the Commission noted that:

It is true that the advantage under the present tax system [of cash basis accounting] is only a deferment of tax in that the cost would ultimately be allowed as a deduction; however, the deferment is equivalent, in relative terms, to an interest-free, unsecured loan, which could be of material amount, and is not granted to businesses generally. The cash basis of computing income has also created an extra incentive for wealthy individuals to establish a farm as a secondary endeavour, because losses reported for the early years of operation would be artificially high due to the write-off of the costs of building up inventories and other assets.

64 R.S.C. 1952, c. 148 (as am.).

65 Edgar J. Benson, Minister of Finance, Proposals for Tax Reform (Ottawa: Queen’s Printer, 1969) at para. 5.53 (“Because this provision [section 13] is intended to prohibit the deduction of personal expenses from taxable income, it would remain in the Act under the new system.”).

House of Commons\textsuperscript{67} committees that held extensive public hearings on the White Paper proposals concurred in that recommendation. In light of this relatively recent history of section 31, and an affirmation of its importance by the Executive, two parliamentary committees, and Parliament itself, it is somewhat surprising that judges and some commentators would wonder about its significance, as if it were an overlooked anomaly in the tax system.

7. History of the Restriction of the Deduction of Farm Losses

Parliament had been concerned about the ability of part-time farmers to offset their farm losses from other income almost from the inception of the income tax, and it has remained a concern throughout the history of the Act. In the original 1917 Income War Tax Act,\textsuperscript{68} all income was netted. There was no restriction on the deductibility of losses from one source of income from gains on another. However, only two years later, a provision was introduced, paragraph 3(f), to provide that, “deficits or losses sustained in transactions entered into for profit but not connected with the chief business, trade, profession or occupation of the taxpayer shall not be deducted from the income derived from the chief business, trade, profession or occupation of the taxpayer in determining his taxable income.”\textsuperscript{69} Although the provision is worded generally, it appears from statements in the House of Commons by the Minister of Finance, Sir Thomas White, that it was targeted primarily at part-time farmers:

Not long ago it was brought to my attention that a man who had a large income took it into his head that he could become a successful farmer. They say when a man does fancy farming he is an “agriculturist”, as distinguished [from] a “farmer” who does real farming and makes money. The “agriculturist” nearly always loses money, and we do not propose to let him set up any loss in this enterprise. We will assess him on his income. We do not desire to discourage him from going into

\textsuperscript{67} Canada, House of Commons, Standing Committee on Finance, Trade and Economic Affairs, Eighteenth Report of the Standing Committee on Finance, Trade and Economic Affairs Respecting the White Paper on Tax Reform (Ottawa: Queen’s Printer, 1970) at paras. 5.48-5.53.

\textsuperscript{68} Income War Tax Act, 1917, S.C. 1917, c. 28.

\textsuperscript{69} This was added as s. 3(1)(f) to the 1917 Act, id., by S.C. 1919, c. 55, s. 2(2), as amended by S.C. 1920, c. 49, s. 2 and S.C. 1923, c. 52, s. 1 (the language was somewhat simplified in 1923 and again in 1927).
farming, but do not think he should set up such losses against a substantial income he derives in the city.\textsuperscript{70}

The next year, a subsection was added providing the Minister with the power to determine “what deficits or losses sustained in transactions entered into for profit are connected with the chief business, trade, profession or occupation of the taxpayer”, and that the Minister’s decision on this question would be “final and conclusive”.\textsuperscript{71} Again, in introducing this amendment, the then Minister of Finance, Sir Henry Drayton, observed that, “[I]n all our large cities, particularly in Toronto, there are a lot of agriculturists, if I may use that word, as distinguished from farmers. I refer to men who make their money in the city, but who have farms just outside the city in connection with they lose money”.\textsuperscript{72}

In 1923, the provision was reworded to read, “[I]n any case the income of a taxpayer shall be deemed to be not less than the income derived from his chief position, occupation, trade, business or calling”,\textsuperscript{73} and in the consolidation of the federal statutes in 1927, paragraph 3(f) became section 10. In part, presumably because the Minister’s determination of a taxpayer’s chief occupation was “final and conclusive”, there were no cases under this provision.

In 1948, the \textit{Income War Tax Act} underwent a major redrafting and was renamed simply the \textit{Income Tax Act}.\textsuperscript{74} Section 10 of the \textit{Income War Tax Act} was retained and with slight redrafting became subsections 13(1) and 13(2). Most notably, the phrase “chief position, occupation, trade, business or calling” was changed to “chief source of income”. This drafting change was made not to change the meaning of the provision, but was made to restrict the deduction of losses on part-time businesses from investment income if that was the taxpayer’s chief source of income.

In 1951, a subsection that singled out farmers and that was almost identical in its wording to the present section 31 was added to section 13 and made retroactive to 1949.\textsuperscript{75} The new provision provided that, where a taxpayer’s “chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income”, the “permissible farming loss deduction from all other sources of income

\textsuperscript{70} \textit{House of Commons Debates}, 13th Parl., 2d Sess., No. 4 (June 24, 1919), at 3991.
\textsuperscript{71} S.C. 1920, c. 49, s. 21.
\textsuperscript{72} \textit{House of Commons Debates}, 13th Parl., 4th Sess., No. 144 (June 8, 1920), at 3241.
\textsuperscript{73} S.C. 1923, c. 52, s. 1 (para. 3(f) was replaced with a rule that deemed the income of a taxpayer to be not less than the income derived from the taxpayer’s chief occupation).
\textsuperscript{74} \textit{Income Tax Act, 1948} (U.K.), 11 & 12 Geo. VI, c. 52.
\textsuperscript{75} S.C. 1950-51, c. 51.
was the lesser of one-half the farming loss for the year or $5,000”. This provision was added not because of new-found concern for part-time farmers, but to codify an administrative practice. Apparently, since the 1920s, as an administrative concession, the CRA had allowed part-time farmers to deduct one-half of their farm losses from other secondary sources of income. With the amendments in 1948, the Department of Revenue stopped extending this administrative concession to part-time farmers. As a result of lobbying from part-time farmers, in 1951 the government decided to codify a form of limited relief for part-time farmers.

With this specific provision applying to part-time farming in place in 1952, the general provision prohibiting taxpayers from netting secondary business losses from their chief source of income was repealed. In justifying targeting the provision specifically at farmers, the Minister of Finance, Hon. Douglas Abbott, stated: “[G]entlemen farmers never make money from their farms. They always lose money; and they write off that loss against income from other sources, such as salary or investment income.” The provision has remained essentially unchanged since 1953. Thus, even this brief review of the legislative history of section 31 shows that Parliament had a strong and ongoing concern over allowing part-time farmers to deduct their losses from other income.

8. Restricting the Deduction of Farm Losses in Other Countries

Finally, in underlining the important tax policy roles played by section 31, it might be noted that part-time farming is a common lifestyle choice in many countries. Moreover, many countries provide farmers with special tax concessions and have some special measures limiting the

76 See Mr. Abbott, Minister of Finance, *House of Commons Debates*, 21st Parl., 92d Sess., No. 5, 1951 (June 13, 1951), at 4054 (in which he speaks of representations made to him to preserve an administrative practice “going back to the early twenties” of allowing part-time farmers to deduct one-half of their losses against other income).


78 The general loss restrictions in s. 13(1) and (2) were repealed by S.C. 1952, c. 29, s. 4. See *House of Commons Debates*, 22d Parl., 3d Sess., No. 3, 1956 (May 27, 1952), at 2626: “Mr. Abbott: The idea of the provision was to limit the deduction which a gentleman farmer may take for income tax purposes against other income as a result of farm losses. It was felt it was no longer necessary to have the definition of principal source of income as contained in the original section.”

79 Id. (Another member of the House followed up with: “They make money in the city and lose it in the country.”)
deduction of losses of part-time farmers. Often this legislation is supported by organizations representing full-time farmers who are concerned with the unfair competition that tax concessions can provide, particularly to high-income part-time farmers and investors. The 1987 Department of Finance’s discussion paper, Tax Issues in Agriculture, reviews some of the expression of these concerns in the U.S. and efforts made in that country up to the 1986 tax reforms to limit the deductibility of part-time farm losses.\(^{80}\) A number of the general anti-tax shelter provisions enacted in the Tax Reform Act of 1986 apply to farm investments.\(^{81}\) Moreover, the general loss rules in the U.S., under which it is presumed an activity is engaged in for profit only if profits occur in any three of five consecutive years (or two of seven consecutive years for horse operations), is applied primarily to farms and horse operations.\(^{82}\)

Australia enacted non-commercial loss rules in 1997 that provide that losses from so-called non-commercial activities cannot be offset against other income. Although the rules are complex, they basically provide that a business loss will be quarantined by the rules unless the business passes either a size test (based either on gross sales or assets employed) or a profitability test (the activity has made a profit in three out of the past five years (including the current year)). Concerned that the rules were not strict enough in applying to so-called “Pitt Street farmers”, in 2009 the government considerably tightened the restrictive loss rules. Basically, if a taxpayer’s total adjusted income is over $250,000, no business losses can be offset against other income.\(^{83}\)

In 2004, South Africa enacted rules under which “ring-fenced assessed losses” cannot be offset against other income but must be carried forward to be deducted against income from the same activities in which the losses were incurred.\(^{84}\) The rules only apply to high-income


\(^{83}\) Naturally, the rules are considerably more complex than this short summary suggests. Among other refinements, taxpayers can apply for an exemption from the rules in limited circumstances. See Julie Cassidy, “Devil’s in the Detail: Non-Commercial Business Losses” (2008) 3:2 Journal of the Australasian Tax Teachers Association 87; Andrew Smith, The Tax Status of Hobbies and Other Loss-Making Activities in New Zealand, online: University of Auckland Business School <http://docs.business.auckland.ac.nz/Doc/59-Andrew-Smith.pdf> [quoted with permission].

\(^{84}\) See South African Revenue Service, Guide on the Ring-Fencing of Assessed Losses Arising from Certain Trades Conducted by Individuals (May 19, 2005), online: <http://www.sars.
taxpayers, those whose income exceeds the level at which the maximum rate of tax applies. They are general rules that apply if the person has made a loss from the activity in any three of the last five years or if the activity being carried on by the person is a suspect trade, namely, a set of listed trades that are often carried on for personal pleasure, including farming. However, reflecting some of the same concerns evident in the Canadian restricted farm loss rules, a person is exempt from the rules if he or she is a full-time farmer.

9. Analysis

This is not a paper on the tax treatment of farm losses — it is a comment on Craig. Nevertheless, this brief review of policy objectives, legislative history and analogous provisions in other countries is meant to illustrate that the problem of restricting the deductibility of losses by part-time farmers is an issue that has been recognized on numerous occasions by legislative bodies. Section 31 performs important tax policy and tax expenditure purposes. Yet in Craig, the Supreme Court appeared to proceed in ignorance of these purposes and history and essentially read the section out of the Act.

In Craig, the Supreme Court, in interpreting the phrase “combination of farming and some other source of income”, held that the restrictive farm loss rules do not apply to part-time farmers as long as their activity is substantial. This means it likely will not apply to high-income taxpayers who make substantial investments in farming. Yet, arguably, that is precisely the kind of person to whom the section should apply. Taxpayers in the highest marginal tax bracket receive the greatest benefit from the farm tax concessions. They are also the ones frequently using country estates as lifestyle choices or running horse breeding and racing businesses as essentially an expensive hobby. Realistically, the Supreme Court’s interpretation means that the section will never apply except possibly to taxpayers who are engaging in farming activities on a small scale without a business purpose, and therefore whose losses would be denied in any event as losses from a hobby.

Moreover, the Supreme Court’s interpretation of the section creates all of the problems it attributed to Moldowan. First, to the extent that the
courts attempt to determine whether the taxpayer’s farming activity is substantial enough to come within the exception the Court fashioned, a good deal of uncertainty will be created around its application. The test calls for a much more difficult factual inquiry than that involved in applying the Moldowan test.

Second, and even odder, the Supreme Court in Craig charged the Court in Moldowan with adding words to the section, namely, that in applying the combination test the farming activity had to be a “sideline” business or, put another way, the taxpayer’s other business had to “predominate”. And yet in this case they also necessarily inserted words into the phrase. The phrase simply provides that the taxpayer’s chief source of income has to be a “combination of farming and some other source of income”. There is no suggestion in the phrase about the relative weight of those activities. It would appear that any farming activity can be combined with any other source of income. The Supreme Court reworded the phrase to read something like a “combination of substantial farming activity and some other source of income”.

Of course, unless words are added, as many commentators and courts have pointed out, the combination test renders the section itself meaningless. So the Court’s choice was to add words or simply to ignore the combination test. In order for the section to achieve its purposes, the Court could have added the words suggested in Moldowan and in the budget documents so that the combination test would read “a combination of farming and some other source of income that is a subordinate source of income for the taxpayer”, or they could have simply ignored the phrase. That is, they could have interpreted the section as if that phrase was not in it. Of course, the Court is reluctant to ignore words and phrases in a statutory provision, but in other areas of law they do it regularly, particularly if they reach a decision that would otherwise lead to an absurd result. In Craig, the Court’s choice was clear: either give the section an interpretation that renders the whole section meaningless (even though the section implements important tax policy and tax expenditure objectives), or give it an interpretation that ignores a phrase used in the section.

There is one more troubling aspect of Craig: why did the Court feel the need to hear a case that might involve overruling one of its previous decisions, Moldowan? The test in Moldowan made sense out of the section, it had been applied by the CRA for over 35 years, there was no evidence that its application was having any adverse economic or other effects, and one might have supposed that if Parliament was unhappy with Moldowan, then Parliament would have amended the Act (in recent
years, since the Court has been taking a more plain meaning approach to the statute, Parliament has been quick to amend the Act in response to decisions it concluded defeated the purposes of the Act. The only criticism of Moldowan came from some practitioners who perhaps represented clients affected by the decision and from judges and others who embrace a formalistic style of legal reasoning.

At the outset, we referred to Craig as illustrating a failure of the judicial process. The adversary system assumes that counsel will fully inform the Court of all the considerations that it needs to take into account in reaching a sensible result. However, because of the Court’s formalistic reasoning, counsel are discouraged from arguing their cases by engaging in a serious discussion of tax policy and the consequences of alternative holdings. Instead, they are encouraged simply to play word games with one another and the Court. That is no way to resolve serious public policy issues.

III. Fundy Settlement v. Canada: A Missed Opportunity

Fundy involved a straightforward issue: how should the residency of a trust be determined for tax purposes? A trust is a person under the Act, as are individuals and corporations, and if a person is resident in Canada he or she is liable to pay tax on his or her worldwide income. Subsection 2(1) of the Act provides no guidance as to how the residency of a trust is to be determined. It simply states that, “[a]n income tax shall be paid [by] … every person resident in Canada”. In effect, the legislature has delegated to the courts the responsibility for formulating a test of trust residency. One might have supposed that, in cases of this kind, the courts would assume responsibility for their lawmaking function and attempt to formulate a test that would satisfy both the purposes the concept serves in the Act and, to the extent possible, the traditional evaluative criteria of equity, neutrality and simplicity. But even in this case, the Supreme Court resorted to formalistic reasoning in resolving the issue.

The issue arose in the context of a blatant international tax avoidance scheme, a scheme that was a variation of a conventional domestic estate freeze. Although the plan was complex, a stylized version will suffice to illustrate how the issue arose. A Canadian taxpayer (Mr. Garron) owned a Canadian manufacturing company (“PMPL”) that he anticipated would
increase substantially in value.\textsuperscript{85} If the company did increase in value, he wished to avoid paying tax on this gain when he sold the shares of the company at some time in the future. Hence, pursuant to a plan devised by his tax advisors, he exchanged his common shares in the company for fixed-value preference shares. He then had the company issue a new class of common shares to a holding company (New Garron Co.) that was owned by a trust (Fundy Settlement). The beneficiaries of the trust were the taxpayer and members of his family. The sole trustee of the trust was a corporate trustee incorporated in Barbados (St. Michael Trust Corp.). As a result of the steps taken in this scheme, the plan was that all future growth in the manufacturing company would accrue to the benefit of the Barbados trust (the holding company owned by the trust held all the growth shares in the manufacturing company). Since the trust was not resident in Canada, the gain would not be taxed in Canada.

Only two years after the implementation of the plan, the trust (Fundy Settlement) sold the shares of the holding company (New Garron Co.) to an arm’s-length purchaser, realizing a capital gain of over $450 million. The trust argued that the gain should be exempt from Canadian tax since, under the terms of the tax treaty that Canada has entered into with Barbados, Canada has agreed that a capital gain realized by a resident of Barbados, even though it is realized on the sale of shares of a Canadian company, will only be taxed in Barbados.\textsuperscript{86} Unsurprisingly, Barbados does not levy a tax on the capital gains of its residents. Hence the plan was to distribute the amount realized on the sales of the shares to the Canadian beneficiaries without any tax being paid on the gain anywhere. However, the scheme depended upon a finding that the Fundy Settlement trust was indeed resident in Barbados and not Canada.

\textsuperscript{85} In fact the company, PMPL Holdings Inc., was owned by Andrew Dunin and a holding company owned by the members of the Garron family and a Garron family trust. In implementing the scheme, two separate holding companies were incorporated to hold the growth shares of PMPL Holdings Inc. and two trusts were established in Barbados, one for each family. The Garron family trust was known as Fundy Settlement.

\textsuperscript{86} Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, January 22, 1980, Can. T.S. 1980 No. 29, Article XIV(4): “Gains from the alienation of any property … may be taxed only in the Contracting State of which the alienator is a resident.” Under the treaty the purchaser of the shares had an obligation to withhold and remit a portion of the sale proceeds to the CRA pursuant to s. 116 of the Act. Fundy Settlement filed a Canadian income tax return on the basis that it was exempt from Canadian tax under the treaty and sought a refund of the amount remitted. The CRA denied the refund and assessed Canadian tax on the gain from the disposition of shares.
Fundy Settlement argued that for tax purposes trusts are resident where the trustee resides. In this case the trustee was a corporate trustee that resided in Barbados. In assessing Fundy Settlement on the gain, the Minister of National Revenue argued that the test for the residency of trusts should be the same as the test for corporations, namely, the central management and control test. Thus, trusts are not necessarily resident where the trustee resides, but where the trust is in fact managed and controlled. And in this case there was ample evidence that the trust was in fact managed and controlled by the beneficiaries, who were resident in Canada.87

1. Lower Courts88

Both lower courts adopted the test for trust residency advanced by the Minister of National Revenue and found that Fundy Settlement was in fact controlled by the beneficiaries in Canada. Therefore, they dismissed the taxpayer’s appeal.

The taxpayer made essentially two arguments as to why the residency of a trust should be where the trustees reside. First, the taxpayer based its argument on an earlier Federal Court Trial Division case, Thibodeau Family Trust v. Canada,89 which had been widely accepted as establishing that a trust is resident in the jurisdiction in which a majority of the trustees are resident.90 Indeed, many tax planning schemes involving offshore trusts, including the one in Fundy, relied upon this reading of Thibodeau.

In Thibodeau, Gibson J. stated that the corporate test of residency, where the central management and control resides, was not an appropriate test to be applied to trusts, since trustees have a fiduciary obligation to manage the trust. In the Tax Court, Woods J. disposed of this reasoning summarily by noting that trustees are not always compliant with their fiduciary obligations.91 Moreover, upon a careful reading of the case, she

87 Alternatively, the Minister of National Revenue argued that the trusts should be taxed in Canada under a deeming rule in the Act that applies to trusts, s. 94(1)(c), and on the grounds that the general anti-avoidance rule (GAAR) should apply to deny the trusts the benefit of the treaty exemption. Although both lower courts dealt with these points, the Supreme Court did not.
91 Garron, supra, note 88, at para. 150.
doubted whether the holding of *Thibodeau* was that in all cases the residency of a trust should be determined to be where the trustees reside. In the Federal Court of Appeal, Sharlow J.A. also doubted whether *Thibodeau* could be read as holding that in every case trusts are resident where the trustees reside, and in any event stated that “if that is what the judge in *Thibodeau* was saying, then I respectfully disagree.”

The difficulty with a test for the residency of trusts that depends simply on where the trustees reside is obvious. It is a formal test. It allows taxpayers to place the residency of a trust in any jurisdiction they choose through the simple expedient of appointing trustees resident in that jurisdiction. The test is tantamount to asking taxpayers where they would like the trusts they are establishing to be taxed. In tax avoidance arrangements involving offshore trusts, it is well understood that the trustees appointed, usually in a tax haven jurisdiction, will simply follow the instructions of the settler or the beneficiaries of the trust.

A second argument the taxpayer made for equating the residency of a trust with the residency of the trustees is that section 104(1) of the Act provides that “a reference to a trust … shall, unless the context otherwise requires, be read to include a reference to a trustee”. In the Tax Court, Woods J. simply stated that this provision did not assist in determining the residence of a trust. Justice Sharlow in the Federal Court of Appeal elaborated, reasoning that to give this effect to section 104(1) would give it a meaning “beyond its words and purpose”. She noted, “[S]ection 104 was enacted to solve the practical problems of tax administration that would necessarily arise when it was determined that trusts were to be taxed despite the absence of legal personality.” She went on to say, “I do not read section 104 as a signal that Parliament intended that, in all cases, the residence of the trust must be the residence of the trustee.” This is surely a correct reading of section 104(1). It strains credulity to imagine that when drafting the section the drafters of section 104(1), or anyone else in the legislative process that might have read the section, had turned their mind to how the residency of trusts should be determined.

In the Tax Court, Woods J. held that the corporate test of residency, where the central management and control of the corporation resides, should also apply to trusts for two reasons. First, she suggested that the reason for adopting the central management and control test for

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92 *Fundy (appeal)*, *supra*, note 88, at para. 61.
94 *Fundy (appeal)*, *supra*, note 88, at para. 64.
corporations applies equally to trusts. To avoid the adoption of a formal test which could be easily manipulated, such as where the corporation was incorporated, early English cases held by analogy to an individual that a corporation should be held to reside where “its real business is carried on”, namely, its “chief seat of management and its centre of trading”. Justice Woods further reflected that the relevant characteristics of corporations and trusts are similar: “The function of each is, at a basic level, the management of property.” Second, she reasoned that, “adopting a similar test of residence for trusts and corporations promotes the important principles of consistency, predictability and fairness in the application of tax law”. She then reviews the evidence at great length and concludes that, “the central management and control of the Trusts was located in Canada and that the Trusts were resident in Canada for purposes of the Treaty”.

In the Federal Court of Appeal, Sharlow J.A. engages in a similar line of reasoning in holding that the corporate central management and control test should also apply to trusts. However, she also gives a reason that begins with a premise about the purpose of the concept of residency: “Generally, the residence of a person is a question of fact, the determination of which requires consideration of any number of factors that point to or away from an economic or social link between the person and a particular country.” She concludes that since the determination of residence for tax purposes should be a factual question, the central management and control test should apply to trusts as well as to corporations. In applying the test, she accepts the Tax Court’s finding of fact that Fundy Settlement was resident in Canada.

2. Supreme Court

The Supreme Court’s decision dismissing the taxpayer’s appeal was written by the Court. It is short and adds nothing to the analysis in the lower courts. The Court rejected the taxpayer’s arguments for adopting

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96 Garron, id., at para. 159.
97 Id., at para. 160.
98 Id., at para. 267.
99 Fundy (appeal), supra, note 88, at para. 53.
100 Id., at para. 62.
101 Fundy, supra, note 17.
102 This type of per curiam decision is usually reserved for constitutional cases where the Court wants to show its unity on an issue.
the test of where the trustees reside for the same reasons as the lower courts. It held that the corporate test of where the central management and control resides was the appropriate test for basically the same two reasons given by Woods J. in the Tax Court. First, trusts and corporations are similar in many respects. The Court lists six similarities: they both hold assets that need to be managed; they both involve the acquisition and disposition of assets; they both require the management of a business; they both require banking and financial arrangements; they both require the instruction of advisors; and they both distribute income.

Second, the Court agreed with Woods J. that adopting the same test for corporations and trusts would promote (and here the Court quoted Woods J.), “the important principles of consistency, predictability and fairness in the application of the tax law”.

3. Analysis

It always makes sense to give meaning to concepts based upon the reason for their use. Thus, the residency of a trust should be determined in a way that furthers the reasons that persons are taxed on the basis of their residency in the first place. But, that inquiry soon gets complicated as applied to trusts (and corporations). Basically, countries assert jurisdiction to tax persons on their worldwide income if those persons have significant social and economic connections with the country, and therefore the country is morally justified in imposing a tax on their income in order to support the government goods and services from which those persons have benefitted. Residency is the legal concept that most countries use to determine whether the nexus between a person and the country meets this standard. The concept works reasonably well as it applies to individuals since all of their connections with the country can be considered. It arguably works less well as it applies to legal constructs like corporations and trusts, and attempting to apply it to them might even be classified as a category error since there is no justification for taxing corporations and trusts in their own right (tax justice principles do not apply to legal constructs). They are taxed simply as a proxy for taxing the individuals who might benefit from the income accumulating

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103 Fundy, supra, note 17, at paras 10-13.
104 Id., at para. 14.
105 Id., at para. 16.
in them. Nevertheless, the Act requires courts to determine the residency of corporations and trusts.\footnote{Over the past number of years, reforms have been made to the income tax in most countries to diminish the significance of the concept of residency as it applies to legal constructs like corporations and trusts.}

Following the lower court decisions, the Supreme Court determined the appropriate test for the residency of a trust largely by reasoning that it should be the same as the test for corporations and applying that test, namely, the central management and control test. In arguing by analogy to corporations, the Court pointed out a number of activities that both trusts and corporations often undertake. It is the case that trusts may carry on many of the same activities as corporations, but they are very different legal constructs. One could point to as many differences between trusts and corporations as similarities. The odd thing about the Court’s formal reasoning by analogy is that the similarities between trusts and corporations that it mentions have little or nothing to do with the reasons for the use of the concept of residency in tax law. The Supreme Court also agreed with the trial judge that adopting the same test for both corporations and trusts would promote “consistency, predictability and fairness”. But this assertion largely begs the question. It would only promote consistency and fairness to apply the same test to both legal constructs if, in fact, the same test should apply to both legal constructs.

What the Court should have done in this case is posit alternative possible tests of trust residency and then choose the one that most nearly captures the reason for the test and that most nearly satisfies the traditional tax criteria of equity, neutrality and simplicity. As mentioned above, the test of where the trustees reside is easily dismissed since the mere presence of a trustee in a jurisdiction is not a strong enough nexus to tax the trust on its worldwide income. Moreover, it is too easy to manipulate.

The corporate test of where management and control is exercised is marginally better. Many trusts involve essentially the holding of property and the subsequent distribution of income and capital. There is often little management to be done by the trustees and, even if there is, that does not provide a strong nexus to a country. It seems odd to argue, for example, that if a trust is formed in a particular country and subject to that country’s laws, and if the settler, beneficiaries and the trust property are all located in that jurisdiction, that the jurisdiction where the trustee resides has a strong
claim to tax the trust on its worldwide income. The trustee might be little more than someone named in a document.

Further, the test of where the central control and management resides is relatively easy to manipulate. In Fundy, the Minister was able to produce evidence that the trust was in fact managed from Canada because the parties were obviously proceeding on the basis that the trust would be resident where the trustees resided. However, now that tax planners are aware that the Minister will be enforcing a test of residency of where the trust is managed, they will be sure to prepare documentation that suggests it was being managed by trustees offshore. In theory, the test should be difficult to manipulate since few taxpayers would be willing to give up control over their property to a trustee in a tax haven even if it meant saving some tax. However, aggressive taxpayers will be careful to prepare a record showing that central management and control was being exercised by the trustees, and it will be difficult for the Minister to gather evidence showing otherwise.

A more sensible test of trust residence would look at all the facts and circumstances relating to the trust and determine whether, based on that factual inquiry, the trust had a sufficiently close nexus with the jurisdiction that it could be justifiably taxed on its worldwide income. The facts would include where the trust was formed; the private law that governs it; where the settler, beneficiaries and trustees reside; the location of the trust’s assets; the location of the trust’s advisors; and where it was managed and controlled. Indeed, the concept of residency is most sensibly applied to individuals, and thus the Court might have more appropriately analogized to individuals instead of corporations in formulating a test of residency for trusts. And, of course, section 104(2) provides that “[a] trust shall, for the purposes of this Act … be deemed in respect of the trust property an individual”. The residency of individuals is determined by examining all of the connections of an individual with the jurisdiction. Also, a facts and circumstances or connecting factors test is used in other areas of tax law where a nexus must be made between income and a jurisdiction. For example, in determining whether “the personal property of an Indian or a band is situated on a reserve” under section 87(1)(b) of the Indian Act, the Supreme Court adopted a connecting factors analysis that it derived from the purpose of the

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107 R.S.C. 1985, c. I-5, s. 87(1)(b).
exemption in section 87. Lastly, in private international law, where no applicable law is chosen, a trust is generally governed by the law with which it is most closely connected.

A final irony of basing the test for the residency of trusts on an analogy to the test for corporations is that, arguably, that test no longer makes much sense even as it applies to corporations. In the leading English case of corporation residency, which the Canadian courts all follow, De Beers, the House of Lords held that a corporation is resident where it “really keeps house and does business” and that “the real business is carried on where the central management and control actually abides”. But why isn’t the real business of a corporation carried on where the raw materials are recovered, where the products are manufactured, where the workers reside, where the products are sold, or where the profits are distributed? The House of Lords chose that test, in part, because as Lord Loreburn reasoned, in the absence of such a test, a corporation could have “its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad”. The policy that those who benefit from the protection of English law should pay taxes in that country was crucial to the court’s decision. When England was the dominant economic and military power and had one of the most advanced legal systems in the world, it might have made sense to suggest that corporations with their central management and control in the U.K. derived substantial benefits from operating out of that country. But now corporations operating around the world are unlikely to be deriving the greatest benefit, or much benefit at all, from the jurisdiction in which their central management and control are located. Consequently, arguably a facts and circumstances or connecting factors test should also be used in deciding on the residency of corporations. Although such a test for corporate residency has been suggested by thoughtful commentators, they recognize that it would create difficulties, particularly in the context of international conventions and treaties. Nevertheless, the obvious shortcomings of the corporate test

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109 De Beers, supra, note 95.
110 Id., at 458.
of residency, even as it is applied to corporations, makes one wonder why anyone would think it was an appropriate analogy in developing a test for trusts.

*Fundy* represents a missed opportunity to develop a test for the residency of trusts based on the legal, political and economic benefits the trust might be deriving from Canada and on the need to have tax rules that are difficult to manipulate.

IV. **Canada v. GlaxoSmithKline Inc.: Making the Tax World Safe for Multinationals**

1. **The Transfer Pricing Problem**

Over the past few years, newspapers, particularly in the U.K. and U.S., have been filled with stories about the failure of large multinationals to pay tax anywhere in the world. Think about the coverage of Amazon,\(^{112}\) Apple,\(^{113}\) Cadbury,\(^{114}\) Ikea,\(^{115}\) Starbucks,\(^{116}\) Google\(^{117}\) and eBay,\(^{118}\) among others. It is now common knowledge that multinationals have deflected trillions of dollars of profits to tax havens. Several international Non-governmental Organizations (“NGOs”), who are primarily concerned with the billions of dollars of taxes that multinationals have avoided paying in the low-income countries in which they operate, have

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118 *Supra*, note 115.
urged a complete revamping of the rules of international tax so that multinationals cannot avoid paying taxes in countries where they earn their profits. However, even organizations representing the most powerful nations in the world, such as the Organisation of Economic Co-operation and Development (“OECD”) and the G8, have joined the call for reforms in international tax that might limit the ability of multinationals to abuse tax systems around the world.

Transfer pricing provides a striking example of what is wrong with the tax rules that apply to multinationals. The facts of *GlaxoSmithKline* vividly illustrate how transfer pricing is no answer to the question of how fairly to allocate multinational profits to countries in which they operate. And the Supreme Court’s resolution of the issue only exacerbates the problems.

Here is how the problem arises. Multinationals invariably have dozens, even hundreds, of subsidiaries operating in countries around the world. Hence, a method must be found to determine how much of a multinational’s worldwide profits have been earned in each country so that each country can levy an income tax on the profits earned in that country. This is done in almost all countries, including Canada, by requiring multinationals to assign prices to all the goods and services that flow between the related members of a corporate group. In tax parlance, these prices are referred to as transfer prices.

Unless prevented from doing so, corporations belonging to a related group of corporations could easily avoid income taxes in a particular country through the manipulation of these transfer prices. For example, to minimize the taxes on its worldwide income, if a multinational has a subsidiary in a country with a high tax rate and it is receiving goods and services from a related corporation in a low-tax country, the transfer price might be set very high. Hence the subsidiary in the high-tax country would have higher expenses and lower profits, while the subsidiary in the low-tax country would have higher profits.

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121 Supra, note 18.
Naturally, most countries have rules that attempt to prevent the manipulation of transfer prices. In Canada, for the period covering the reassessment of GlaxoSmithKline, 1990-1993, section 69(2) provided that where a taxpayer has paid … to a non-resident person with whom the taxpayer was not dealing at arm’s length as price … for … any property … an amount greater than the amount … that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length, the reasonable amount shall … be deemed to have been the amount that was paid.\footnote{Id., at para. 18 (S.C.J.). In 1998 the rule was moved and revised. It is now s. 247 of the Act. Although it is differently worded, the effect is the same.}

Although the wording of the rules differs from country to country, almost every country has adopted rules that require related corporations to determine their transfer prices based on what is referred to as the arm’s-length standard. Basically, the rules require that transfer prices reflect the price for the goods and services transferred that would have been charged on a sale between unrelated enterprises. The obvious objective of the arm’s-length standard is to require taxpayers engaging in a transaction with related parties to report for tax purposes the income that they would have earned if they had engaged in a comparable transaction with unrelated parties. Hence the standard promotes tax parity between those taxpayers that engage in transactions with related parties and those otherwise similarly situated taxpayers that engage in comparable transactions with unrelated parties.

2. Facts and Issue

As it has been known since 2000, GlaxoSmithKline, a U.K. multinational, is one of the largest pharmaceutical companies in the world. One of its wholly owned subsidiaries, Glaxo Group, also a U.K. corporation, in turn, wholly owns Glaxo Canada. In 1988, Glaxo Canada and its parent corporation, Glaxo Group, entered into a licensing agreement (which replaced a somewhat similar consultancy agreement that the two companies had entered into in 1972) under which, in return for a royalty of six per cent on the net sale of drugs in Canada, Glaxo Canada received the following services and intangibles from its parent corporation: the right to manufacture, use and sell products; the right to use the trademarks owned by Glaxo Group, including Zantac; the right to receive technical
assistance for its secondary manufacturing requirements; the right to use registration material prepared by Glaxo Group; access to new products, including line extensions; access to improvements in drugs; the right to have Glaxo Group companies sell to Glaxo Canada any raw materials; marketing support; and indemnification against damages arising from patent infringement actions.

In 1976, Glaxo Group discovered the pharmaceutical ingredient ranitidine, which is used to relieve stomach ulcers without the need for surgery. The manufacture of the drug was undertaken, in part, by a related corporation in Singapore, where the manufacturing of the drug benefited from a 10-year tax holiday and then a low rate of tax of only 10 per cent. The Singapore manufacturing company sold the drug to another related corporation in Switzerland, Adechsa.

In 1982, Glaxo Canada began selling ranitidine in Canada under the brand name Zantac. In 1983, Glaxo Canada entered into a supply agreement with its sister corporation in Switzerland, Adechsa, for the purchase of ranitidine. In calculating its profits in Canada between 1990 and 1992, Glaxo Canada deducted the transfer price that Adechsa charged it for the ranitidine, between $1,512 and $1,651 per kilogram. During the same period, two Canadian generic drug companies were purchasing their ranitidine from arm’s-length manufacturers for between $194 and $304 per kilogram, or between five to seven times less than the transfer price Glaxo Canada was being charged by its sister corporation. The basic tax planning is obvious and was noted by Rip A.C.J. (as he then was) in the Tax Court. By charging a high price for ranitidine in Canada, the corporate group was moving amounts that would otherwise be taxed in Canada at a corporate rate of about 45 per cent to Switzerland and then on to Singapore, where the amounts benefited from a tax holiday.

In reassessing Glaxo Canada, the Minister of National Revenue disallowed the deduction of the price paid to Adechsa in excess of the highest monthly price per kilogram of ranitidine paid by the two Canadian generic pharmaceutical companies to their unrelated suppliers. Any amount paid over that the Minister treated as a dividend distribution. This amount would not be deductible from profits and a withholding tax would be imposed. The disallowance was based on section 69(2), quoted above, and which applies where a taxpayer is not dealing at arm’s length.

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with a non-resident and pays an amount greater than the amount, “that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length”.

A number of methods might be used in determining whether transfer prices are reasonable. However, the most widely accepted method is commonly referred to as the comparable uncontrolled price (“CUP”) method. This involves finding an appropriate arm’s-length transaction with which to compare the transaction to which the transfer price has been assigned. Obviously the circumstances surrounding the two transactions have to be similar if the comparison is to be valid. In this case, the Minister of National Revenue argued that the most appropriate comparators were the other Canadian companies buying ranitidine from arm’s-length manufacturers. The taxpayer argued that those cases were not comparable because Glaxo Canada was not just paying for ranitidine from Adechsa but was paying as well for a number of intangibles from which it benefited as a member of the corporate group and as a result of the licensing agreement it had entered into with Glaxo Group. Just looking at the amount paid to Adechsa as being for the purchase of tangible property did not reflect the economic and business realities of Glaxo Canada. When all of the relevant surrounding circumstances were considered, an amount equal to five to seven times the market price of ranitidine was not an unreasonable transfer price.

The Supreme Court stated the issue in the case this way: “what circumstances are to be taken into account in determining the reasonable arm’s-length price against which to compare the non-arm’s-length transfer price?”

3. Tax Court of Canada

In a lengthy and thorough judgment, Rip A.C.J. (now Chief Justice of the Tax Court) essentially upheld the Minister’s reassessment. He held that

124 The Organisation for Economic Co-operation and Development published an extensive commentary on transfer pricing methodology in 1979, which it updated in 1994. Most countries rely on these commentaries in analyzing transfer prices. They were dealt with extensively by the Tax Court of Canada in this case and referred to by both the Federal Court of Appeal and the Supreme Court. Organisation for Economic Co-operation and Development, Transfer pricing guidelines for multinational enterprises and tax administrators: report of the OECD Committee on Fiscal Affairs (Paris: OECD Publications, 1994).

125 GlaxoSmithKline, supra, note 18, at para. 3.

126 Supra, note 123.
it would only have been reasonable for Glaxo Canada to pay Adechsa an amount equal to the highest price paid by the generic pharmaceutical companies. Amounts paid in excess of that should be treated as a dividend distribution or a benefit the taxpayer desired to have conferred on Adechsa, and as such were non-deductible and should be subject to non-resident withholding taxes.

In determining that the transfer prices were unreasonable, he concluded that the CUP method was appropriate and that the purchases of ranitidine made by the two generic pharmaceutical companies from arm’s-length suppliers were comparable to the purchases that Glaxo Canada made from Adechsa.

He reviewed at some length all of the factors the OECD suggest should be considered when determining whether two transactions are comparable (from the OECD commentary on transfer pricing methodology). He found that, in this case, the purchases by the Canadian companies were comparable to Glaxo Canada’s purchases from its related company.\(^\text{127}\) Further, he stated that, “in the appeals at bar, the business circumstances and strategies that the appellant submits distinguish it from the generic companies have no bearing on the transfer pricing issue.”\(^\text{128}\)

The taxpayer argued that one consideration which distinguished the transfer prices from the uncontrolled prices was that Glaxo Canada was contractually bound to purchase the drug from a related corporation. In holding that this did not make them “reasonable in the circumstances”, Rip A.C.J. stated: “If the legislation intended that the phrase ‘reasonable in the circumstances’ in subsection 69(2) should include all contractual terms there would be no purpose to subsection 69(2); any MNE [Multi-national Enterprise] would be able to claim that its parent company would not allow it to purchase from another supplier.”\(^\text{129}\)

Associate Chief Justice Rip also concluded that the intangible rights provided to Glaxo Canada under the licensing agreement with Glaxo Group were not relevant in determining the appropriate transfer price for the ranitidine. He noted that the benefits these intangibles provided Glaxo Canada were paid for in an entirely separate transaction and with a different party (Glaxo Group, not Adechsa). Although he appeared to find, after a consideration of all the facts and circumstances, that the licensing agreement was entirely separate from the supply agreement,

\(^{127}\) Id., at paras. 119-142 (T.C.J.).
\(^{128}\) Id., at para. 92.
\(^{129}\) Id., at para. 89.
he also suggested that as a matter of law he could not consider the licensing agreement in assessing the reasonableness of the supply agreement. He referred to a Supreme Court of Canada case, Singleton v. Canada, as holding that, in characterizing a particular legal transaction, other transactions or economic realities should be ignored: “I agree with the respondent that the Supply Agreement with Adechsa and the Licence Agreement with Glaxo Group cover separate matters and that they are to be considered independently as required by Singleton.”

4. Federal Court of Appeal

The Federal Court of Appeal held that Rip A.C.J. had made an error in law in interpreting the clause “reasonable in the circumstances” in section 69(2), and therefore overturned his decision. The error he made was in holding that he could not consider all of the circumstances surrounding the transfer price charged in determining whether it was reasonable. In particular, he should have considered the terms of the licensing agreement in deciding whether or not the prices charged in the supply agreement were reasonable. In arriving at a reasonable price, the test is not what a reasonable person might pay in the open market for the ranitidine, that is, its fair market value, but “whether any reasonable business person, dealing at arm’s length with Adechsa, would have paid the price paid by the appellant for its ranitidine”. And in making that judgment, the judge should have considered all of the circumstances surrounding the relationship between Glaxo Canada and Adechsa. These circumstances included the fact that “Glaxo Group owned the Zantac trademark …. Zantac commanded a premium over generic ranitidine drugs. Glaxo Group owned the ranitidine patent … [and] [w]ithout the License Agreement, the appellant would not have been in a position to use the ranitidine patent and the Zantac trademark”. Because of these circumstances, and because it was required to buy ranitidine from a member of the corporate group, Glaxo Canada would be willing to pay more for the drug than a generic pharmaceutical company purchasing ranitidine.

131 Supra, note 123, at para. 78.
133 Id., at para. 70.
134 Id., at para. 79.
The Federal Court of Appeal sent the case back to the Tax Court for a re-hearing of the appropriate transfer price so that all the relevant circumstances surrounding the transaction could be taken into account.

5. Supreme Court

In a unanimous decision, written by Rothstein J., the Supreme Court dismissed the Minister’s appeal and essentially followed the Federal Court of Appeal’s reasoning. In determining the reasonableness of transfer pricing, the question is what price an arm’s-length person would have paid in circumstances similar to those faced by the taxpayer. This inquiry might require going beyond the facts of the particular transaction and examining all of the surrounding circumstances, in particular the taxpayer’s economic and business realities. In this case, that would include the terms of the licence agreement.

Justice Rothstein stated that, as a justification for ignoring the licensing agreement, Rip A.C.J. had misconstrued Singleton. He discussed at some length how that case dealt with an entirely different issue.\textsuperscript{135} In this case, he held that the licence agreement was a relevant circumstance and the most important reason that, “the generic comparators [used by Rip A.C.J.] do not reflect the economic and business reality of Glaxo Canada”.\textsuperscript{136} The following paragraph summarizes why he found that it was necessary to consider the licence and supply agreements together in order to arrive at a realistic picture of the profits of Glaxo Canada:

It cannot be irrelevant that Glaxo Canada’s function was primarily a secondary manufacturer and marketer. It did not originate new products and the intellectual property rights associated with them. Nor did it undertake the investment and risk involved with originating new products. Nor did it have the other risks and investment costs which Glaxo Group undertook under the license agreement. The prices paid by Glaxo Canada to Adechsa were a payment for a bundle of at least some rights and benefits under the License Agreement and product under the Supply Agreement.\textsuperscript{137}

To the extent that part of the purchase price paid under the supply agreement was compensation for rights provided in the licence agreement, Rothstein J. stated that these amounts might be royalties for

\textsuperscript{135} Supra, note 18, at paras. 33-38.  
\textsuperscript{136} Id., at para. 53.  
\textsuperscript{137} Id., at para. 52.
intellectual property rights, such as being able to sell ranitidine under the trade name Zantac, and that to the extent that part of the purchase price was for these rights, there should have been a non-resident withholding tax imposed. 138 But apart from these rights to intellectual property, he said that the licensing agreement also gave Glaxo “guaranteed access to new products, the right to the supply of raw materials and materials in bulk, marketing support, and technical assistance for setting up new product lines”. 139 These rights, along with other considerations, such as the “certain degree of comfort” Glaxo Canada had in purchasing from a related corporation that had demonstrated “good manufacturing practices”, all had value and consideration for them was presumably included in the transfer price. 140

Following the judgment of the Federal Court of Appeal, Rothstein J. remitted the matter back to the Tax Court to re-determine a reasonable transfer price, “having regard to the effect of the Licence Agreement on the prices paid by Glaxo Canada for the supply of ranitidine from Adechsa”. 141

6. Analysis

The Supreme Court did not settle any general proposition of law in this case. In applying the arm’s-length principle by use of the CUP method, it is indisputable that all economically relevant circumstances must be considered in ensuring that the comparator arm’s-length transaction is sufficiently comparable to the contested non-arm’s-length transaction. However, the Court’s judgment might be read as suggesting that, in almost all cases, the business and economic circumstances surrounding a taxpayer who is a member of a corporate group distinguishes its transactions with related corporations from arm’s-length transfers. If read this broadly, it would be almost impossible for tax departments to regulate transfer prices. In every case, myriad unique circumstances will distinguish transfers between related corporations from transfers between unrelated corporations.

In this case, the Court held specifically that both the licence and supply agreements that Glaxo Canada had entered into — one with its

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138 Id., at para. 57.
139 Id., at para. 58.
140 Id., at para. 59.
141 Id., at para. 76.
parent corporation for certain intangibles and the other with its sister corporation for the supply of ranitidine — were relevant in arriving at a realistic picture of the profits of Glaxo Canada. That proposition surely cannot be correct.

First, the rights that Glaxo Canada had acquired under the licence agreement with its parent had been paid for separately. Under that agreement, Glaxo Canada was obligated to pay its parent a royalty of six per cent of its net sales for the intangibles offered in the agreement. Hence, if part of the purchase price for the ranitidine included an amount for these rights, Glaxo Canada would be paying for them twice. It might be that the royalty paid under the licence agreement was too low and therefore part of the purchase price was compensating for the low royalty, but if the royalty was too low the obvious solution would have been to increase the royalty. A royalty payment would, of course, have been subject to non-resident withholding tax. So, perhaps what the taxpayer was attempting to do was to convert a royalty payment into a payment for the cost of goods sold, which would be fully deductible from its profits with no withholding tax required to be remitted. If so, they should not have gotten away with it.

Second, the rights under the licence agreement, and the other advantages that Glaxo Canada received by being a member of the corporate group, were conferred on it by Glaxo Group, its parent corporation. Payments for these rights should be made to its parent corporation in the U.K. Why would the payments be made to Adechsa in Switzerland? Adechsa did not own the rights under the licensing agreement.

Third, if the transfer price that Glaxo Canada paid Adechsa included an amount for the ranitidine as well as certain intangibles, then those advantages should have been unbundled. Most of the advantages that the Supreme Court mentioned that Glaxo Canada derived from the licensing agreement had little to do with the distribution of Zantac in Canada. They should have been separately characterized and priced.

Finally, the question as to whether the licensing agreement was a relevant consideration in determining the reasonableness of the transfer price that Glaxo Canada paid to Adechsa is a factual question that requires a careful review of all the facts and circumstances. In the Tax Court, Rip A.C.J. carefully and exhaustively reviewed all of the facts and circumstances of the case. Unfortunately, he did not explicitly find on the basis of the facts and circumstances that the licensing agreement was not relevant, but instead stated that he was bound by Singleton not to consider the licensing agreement. This enabled the higher courts to hold that he
had made an error in law, but given his general findings it should have been beside the point.

In terms of attempting to rein in tax avoidance by multinationals, there are more troublesome difficulties with the Supreme Court’s judgment. On one reading, the Supreme Court seems to be suggesting that the tax department has to take into account, as part of the relevant circumstances in comparing a transfer price to an arm’s-length price, the corporate group’s worldwide pricing strategy. But, of course, that is precisely what the arm’s-length standard is designed to avoid. Invariably, one important purpose of the corporate group’s worldwide pricing strategy will be to minimize its worldwide taxes. Glaxo Group’s worldwide pricing strategy was relevant in considering whether Glaxo Canada was paying a reasonable transfer price, and it would have been relevant to a third party if it were assumed they were similarly a member of the corporate group, but it would not be reasonable if the third party were not a member of the group, which is precisely what the arm’s-length standard attempts to test.

If the Supreme Court’s insistence that the unique circumstances of being a member of a corporate group is relevant to the determination of a reasonable transfer price is followed, and particularly if multinationals are allowed to bundle intangibles as part of every transaction, it will be impossible to find a comparable arm’s-length transaction. If the tax department has to consider all the contractual terms binding members of a corporate group, there would be no point to the arm’s-length standard. The benefits of the comparable uncontrolled price standard are that it provides some certainty in regulating transfer prices, makes it more difficult for multinationals to manipulate their transfer prices, and is easier to enforce. Even in this case, as conducted, the Tax Court sat for 47 days, heard from 10 expert witnesses and 25 other witnesses, and was presented with more than 23,000 pages of documents filed as exhibits. The holistic approach to transfer pricing advocated by the Supreme Court will only further complicate the factual issues that have to be resolved and thus further facilitate tax avoidance. Further, it appears inconsistent with the OECD commentaries on transfer pricing.

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142 Amir Pichhadze, “Canada’s Transfer Pricing Test in the Aftermath of GlaxoSmithKline Inc.: A Critique of the Reasonable Business Person Test” (2013) 20:3 International Transfer Pricing J. 144 (arguing that the decision is so mistaken in its analysis that the Court should on the first possible occasion overrule its own decision).
At the end of his judgment, Rothstein J. offered guidance to the Tax Court for redetermining whether the transfer prices in the case are reasonable. First, he stated: “It is doubtful that comparators will be identical in all material respects in almost any case. Therefore, some leeway must be allowed in the determination of a reasonable amount.” Second, he advised that the trial judge must consider the functions, resources and risks inherent in both Glaxo Canada and its parent corporation. And third, Rothstein J. stated that, “the interests of Glaxo Group and Glaxo Canada must both be considered” 143

This is an odd list of guiding factors. It is unclear why the guidelines give such emphasis to the interest of the parent corporation since it was not a party to the transaction. But more importantly, they all suggest that multinationals must be given more leeway in setting their own transfer prices. Instead of these guidelines, why didn’t Rothstein J. caution the courts below about the need to review transfer prices in a way that would reduce the ability of multinationals to avoid taxes, or about the need to proceed in a way that would provide certainty and that could be reasonably enforced? Or indeed, why didn’t he bemoan the obvious and egregious attempts at tax avoidance that the corporate group was attempting in this case and the serious costs such tax avoidance imposes on the tax system? Tax avoiders such as GlaxoSmithKline may need this kind of rigorous examination. 144

V.  CALGARY  (CITY)  v.  CANADA: GUIDANCE IN APPLYING THE GST

This case involves the application of the GST, 145 and is only the second GST case the Supreme Court has heard. 146 The federal government enacted the GST in 1991. Two general GST issues that have been frequently litigated in lower courts were raised in the case: whether a particular supply of goods and services (in this case, transit facilities and transit services) constituted a

143 Supra, note 18, at paras. 61-63.
144 In 2006, GlaxoSmithKline agreed to pay US$3.4 billion to the Internal Revenue Service (“IRS”) to settle a transfer pricing dispute that involved the sale of Zantac and other drugs in the U.S. It was the largest settlement in IRS history. See Internal Revenue Service, “IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute” (September 11, 2006), online: <http://www.irs.gov/uac/IRS-Accepts-Settlement-Offer-in-Largest-Transfer-Pricing-Dispute>.
146 The first GST appeal was heard in 2009 in United Parcel Service Canada Ltd. v. Canada, [2009] S.C.J. No. 20, [2009] 1 S.C.R. 657 (S.C.C.), where it was unanimously decided that a customs broker was entitled to a rebate for overpaying GST.
single supply or multiple supplies, and whether a grant or subsidy was given (in this case, by the Province of Alberta to the City of Calgary) for a public purpose or was consideration for a supply. No interpretive issue was raised in the case: it simply involved applying well-accepted concepts of a consumption tax to particular facts.

For those unfamiliar with the operation of the GST, some background on the tax is necessary to understand the issues.

1. Overview of the GST

In principle, the GST is a tax on the final consumption of all goods and services in Canada. Its incidence is equivalent to a single-stage retail sales tax that is imposed on all goods and services consumed by individuals. However, instead of being a single-stage sales tax, the GST is a multi-stage sales tax. It is imposed not only on transfers to individuals for final consumption, but also on all transfers of goods and services (in the GST legislation referred to collectively as supplies) between all businesses at every stage of the production and distribution process. All qualifying businesses must register and collect the GST. Business is defined broadly in the legislation and does not require a profit motive. Thus, charities and even public sector organizations are required to register and collect the tax on their supplies if they are engaged in “commercial activities” (again, a term that is defined broadly). It makes sense to apply the GST to charities and public sector organizations since they often provide goods and services to individuals, and if the tax is to be a comprehensive tax on the value of goods and services consumed by individuals, these entities must be required to collect the tax on the goods and services they provide. However, as described below, and an important fact in this case, many public sector organizations engage in activities with a public purpose (such as public transit services) on which, in part for policy reasons, the GST is not levied on the final consumer.

Although all businesses are charged the GST on their purchases, a mechanism is provided to refund the tax paid by businesses because the tax is intended to be a tax on only the final consumption of individuals. This objective is achieved through the mechanism of an “input tax credit”. When a business sells supplies, it collects the tax from the purchaser; however, it is entitled to claim an input tax credit for the tax it paid on its own purchases. Hence it only remits to the government the
difference between the amount of GST it collects on its sales and the amount of any input tax credit to which it is entitled. Input tax credits relieve business inputs of GST and thus avoid the pyramiding of the tax while firms increase the value of goods and services throughout the production and distribution process. Consequently, the GST is actually paid by each business only on the value that it has added to the supply. For that reason, in most countries, the GST is called a value-added tax (“VAT”). The full GST is eventually paid by individual consumers. Although the businesses from which they purchase supplies will have collected the tax on their behalf, individual consumers cannot claim an input tax credit. This multi-stage method of collecting a sales tax from consumers might sound convoluted, but it operates relatively smoothly, increases compliance and, just as importantly, ensures that business inputs do not bear the tax — that is to say, it ensures that all of the tax is passed on to individual consumers.

There is one other aspect of the GST that is important in understanding the legal issues in this case. Under the GST, supplies of goods and services are divided into three categories — taxable supplies, zero-rated supplies and exempt supplies. If suppliers supply a “taxable supply”, they must charge the GST to the purchaser and they are entitled to claim the full input tax credit for any GST they might have paid on their related purchases to provide the supply. This is how the tax should operate for all supplies. However, for policy reasons, some supplies are “zero-rated” and others are “exempt”. If suppliers supply a “zero-rated supply”, they do not charge the GST on the sale, and they may claim the full input tax credit on purchases used to provide the supply. Hence zero-rated supplies are completely exempt from the GST. In Canada, prescription drugs, medical devices, basic groceries, and exported goods and services are zero-rated — they do not bear GST. If suppliers supply an exempt supply, they do not charge the purchaser GST, but the suppliers are not entitled to an input tax credit in respect of purchases to provide the supply. Hence, paradoxically, although these goods and services are referred to as exempt, in fact the GST that the supplier paid on the purchases attributable to the exempt supplies will be buried in the cost of the goods and services to the ultimate purchaser. Examples of exempt goods and services include health care and child care services, educational services, most financial services, sales of residential housing and rentals of residential premises, and some supplies by public sector organizations that serve a public purpose such as municipal transit services.
2. Facts

Against this background, we turn to the facts of the case. The City of Calgary is a registrant under the GST and therefore has to pay GST on all of its purchases. To the extent that it makes taxable supplies to another entity or an individual, it is entitled, by claiming an input tax credit, to a refund of the GST it pays on the purchases related to those supplies. However, to the extent that it makes exempt supplies, it will not collect the GST on the provision of those supplies, but neither will it be entitled to claim an input tax credit for the GST it paid on its purchases related to those supplies.

One of the significant exempt supplies made by the City of Calgary is “municipal transit services” provided to members of the public. Hence, the users of the Calgary municipal transit services are not directly charged GST for this service. Naturally, in the course of providing transit services to the public, the City acquired and constructed transit infrastructure, stations, and equipment such as trains and buses (transit facilities). It paid GST on all the purchases necessary to acquire or build these transit facilities. For a number of years, the City treated these purchases as relating to the exempt supply of providing transit services to the public and therefore did not claim an input tax credit for the GST paid in relation to the purchases. However, in 2003 it changed its tax filing position and claimed input tax credits for a number of these purchases, arguing that they did not relate to the exempt supply of transit services to the public, but instead related to separate taxable supplies of transit facilities that it had made to the Province.\footnote{In most instances, little would be gained by a registrant in taking this position since, while they would be entitled to input tax credits on their purchases, their supply of taxable goods and services would be taxable. In this case, however, the supply was being made to the Province of Alberta and, under the Canadian Constitution, provinces are not required to pay the GST. Thus, a supply to the Province would be effectively treated as a zero-rated supply. Some provinces, notably those provinces that have coordinated their provincial sales taxes with the federal GST, have agreed to pay the tax on their purchases.} The City supported its claim that it had made a separate taxable supply of transit facilities to the Province by noting that the Province had provided substantial funding for these transit facilities pursuant to contractual obligations it had undertaken with the City. On this basis, in filing its January 2003 GST return the City claimed a refund of $6.3 million from the federal government for GST that it had paid on
its purchases for the construction of transit facilities and for which it had not received a rebate.\textsuperscript{148}

The CRA assessed the City and denied its right to claim these input tax credits. It argued that the City was only making one supply, namely, transit services to the public, which were an exempt supply, and hence input tax credits could not be claimed on purchases related to the supply. Further, the CRA argued that the City did not make a supply for consideration to the Province. The funding the Province provided to the City for the transit facilities was a public purpose subsidy and not consideration for a supply. The City appealed to the Tax Court of Canada, which allowed its appeal.

3. Tax Court of Canada\textsuperscript{149}

Associate Chief Justice Rossiter of the Tax Court did not address the question of whether on the facts of this case there could be two supplies or whether all the elements of the transactions should be treated simply as one supply. He assumed there could be two supplies — one involving the construction of the transit system and the other its operation. Instead he only dealt with the issue of whether the funding the Province provided for the transit facilities was consideration for a supply.

He carefully reviewed the logic of the GST legislation and determined that the case turned on whether or not the Province had paid consideration for the supply of transit facilities from the City. Referring to the relevant definitions in the Act, as well as a leading Federal Court of Appeal case on the distinction between funding for a public purpose and consideration for a supply, \textit{Commission scolaire Des Chênes v. Canada},\textsuperscript{150} he held that “in order for the funding provided by the Province of the

\textsuperscript{148} Certain public sector organizations, including municipalities, receive a partial rebate of the GST paid on their purchases. The reason for this partial rebate scheme is that, prior to 1991, the former federal sales tax would have been buried in the price of many purchases made by public sector organizations. When the GST was introduced, although public sector organizations would have to pay GST on their purchases, the federal government indicated that they would not pay more tax than they did under the former federal sales tax. Hence, the government introduced a scheme of partial rebates for the GST paid by these organizations. The City of Calgary was entitled to claim a rebate of 57.14 per cent of the GST it paid. The refund it was claiming in this case was the difference between that amount and a full refund of the tax it had paid over several years. After this case, in February 2004, the public service body rebate for municipalities was raised to 100 per cent.


Appellant to constitute consideration, (1) it must have been provided pursuant to a legal obligation (contractual or otherwise), and (2) it must be closely enough linked to a supply that it may be regarded as having been made ‘for’ that supply.”

Justice Rossiter reviewed the various agreements that the Province had entered into with the City for the provision of the funding and concluded that they imposed a legal obligation on the Province to provide the funding and that this contractual obligation itself resulted in “a direct link between the funding provided by the Province and the supply in question”.

He explained, “[A]s noted by the Federal Court of Appeal in Des Chênes … a payment made under a contract will inevitably meet the requirement of a direct link since the very existence of the obligation to pay is conditional on the co-contracting party fulfilling the corresponding obligations under the terms of the contract.”

One difficulty with the City’s argument that it had made a taxable supply to the Province was that the Province did not appear to have received anything in return for its funding. The City retained ownership of all the transit facilities and used them in supplying transit services to the Calgary public. However, again relying on Des Chênes, Rossiter J. noted that in order for the funding to constitute consideration, it was not necessary for the Province to have received something itself. What the Province received was the provision of transit services to the Calgary public.

4. Federal Court of Appeal

On appeal, the Federal Court of Appeal held that the Tax Court judge had misinterpreted the agreements between the City and the Province. Writing for the court, Pelletier J. held that those agreements did not require the City to provide the Province with a transportation system, but instead they were simply funding agreements under which the funds for approved projects were to be disbursed and administered. The general
issue of distinguishing between public purpose grants and consideration for a supply was not discussed, nor was Des Chênes or any other case that had dealt with this distinction. The court simply suggested that unless the funding was paid in return for a contractual obligation to provide specific supplies, which are transferred to the Province, the funding would not amount to consideration for a supply. As Pelletier J. noted, “[T]here is nothing in … [the agreements] which requires the City to construct anything whatsoever. … [I]t is … an error to construe these agreements in such a way so as to make the City the Province’s general contractor for the construction of a municipal transit system.”

5. Supreme Court

The City was granted leave to appeal to the Supreme Court. The Supreme Court dismissed the City’s appeal in a unanimous decision written, as perhaps has become obvious from the review of the previous cases, by the Court’s leading tax member, Rothstein J. The Court dealt with the case as largely a question of whether the City was making, for the purposes of the GST, a single or multiple supplies. It held that the City was making only a single supply, namely, the supply of municipal transit services. Therefore, all of the inputs into this supply, including the acquisition and building of transit facilities, were part of the single supply of these services. Since these supplies, the municipal transit services, were exempt under the GST no input tax credits were allowed. As Rothstein J. explained:

The City made only one supply: the exempt supply of a municipal transit system to the public. Fulfilling the accountability obligations under the funding agreements with the Province did not result in a separate supply to the Province. The acquisition and construction of transit facilities was an input to the single supply of the municipal transit service to the Calgary public.

The most frequently cited case in Canada on the issue of whether a transaction amounts to a single or multiple supplies has been the Tax Court judgment of Rip J. (as he then was) in O.A. Brown Ltd. v. Canada. In that case, Rip J. said that in making this determination,

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156 Id., at paras. 52-53.
157 Calgary, supra, note 19.
158 Id., at para. 3.
“The test to be distilled from the English authorities is whether, in substance and reality, the alleged separate supply is an integral part, integrant or component of the overall supply”. And, “[O]ne should look at the degree to which the services alleged to constitute a single supply are interconnected, the extent of their interdependence and intertwining, whether each is an integral part or component of a composite whole”.160 These observations are invariably cited in cases on this issue and Rothstein J. dutifully quotes them. He then notes that if the approach in O.A. Brown is followed, “the public transit facilities would not be a separate supply, but would be an input to, or part and parcel of, the supply of the municipal transit service to the Calgary public”.161

In support of his holding that “the alleged separate ‘transit facilities services’ supply is an integral part … of the overall supply of ‘public transit services’”, he cited a number of factors that should be considered in determining whether individual elements being supplied should be treated as a single supply. These factors include: if the alleged separate supply is simply “work of a preparatory nature to another supply” (in this case he found that transit facilities services “was work of a preparatory nature to the supply of a municipal transit service to the public”); if the alleged supply is not a distinct element (in this case he found that “the alleged separate supplies are so interconnected that it would be difficult to identify distinct elements or components”); and, if the alleged supply does not result in a stand-alone good or service (in this case he found that the “transit facilities have no use and provide no service except to the extent to which they are deployed for use within the Calgary municipal transit service”).162

The City argued that the single supply concept could not apply where there were two separate recipients. Therefore, Rothstein J. went on to consider whether or not the Province received a separate and distinct benefit from the City. In finding that it did not, he noted that the Province was under no statutory obligation to provide transit services for the public in its cities. The relevant legislation simply provided that the Province could assist in funding the cost of such facilities. Moreover, once the facilities were completed, title to the facilities was vested in the City, not the Province. He agreed with the Federal Court of Appeal that the correct interpretation of the contracts between the City and the Province was that

160 Calgary, supra, note 19, at paras. 35-36.
161 Id., at para. 39.
162 Id., at paras. 42-45.
they were simply agreements to provide funding for which the City would be responsible and not contracts for the supply of a service. Moreover, he added that “[w]hether or not the Province is a recipient of the supply in addition to the public, the supply is of a municipal transit service to the public, and is therefore exempt.”\(^{163}\) Consequently, he concluded that the City was not entitled to claim input tax credits for the GST that it paid in acquiring and constructing the transit facilities, even though it had received funding for the project from the Province.

6. Analysis

This case does not resolve any important policy or interpretive issue relating to the GST and it is puzzling that the Supreme Court agreed to hear the appeal, in particular since the decision is no longer directly relevant to municipalities given they are now entitled to receive a 100 per cent public service body rebate on the GST they pay.\(^{164}\)

In holding that there was only a single supply in the case, the Supreme Court drew its reasoning from established cases. When the Tax Court of Canada first confronted this issue under the GST, it borrowed heavily from the U.K. and E.U. jurisprudence in establishing a test for making the distinction.\(^{165}\) The Supreme Court simply confirmed some of the key factors to be considered in distinguishing single from multiple supplies.

On the issue of when a transfer payment (a grant, contribution, subsidy and similar payment) should be treated as consideration for a supply, the Supreme Court did clarify the reach of the Federal Court of Appeal’s decision in Des Chênes.\(^{166}\) That case had suggested that if a municipality has a legal obligation to use a provincial subsidy for a particular purpose, then that was a sufficient link to find that the subsidy was consideration for a supply, in that case the supply of school bus services. In this case, in holding that the agreements between the Province and the City were more in the nature of “accountability agreements” (to ensure public grants were applied for their intended purpose), instead of “supply of

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\(^{163}\) Id., at para. 65.

\(^{164}\) Since February 2004 the public service body rebate for municipalities has been 100 per cent.


\(^{166}\) Calgary, supra, note 19.
service agreements”, the Supreme Court made it clear that just because conditions are attached to a transfer payment to make sure it is being used for its intended purpose, this will not necessarily mean it will be treated as consideration for a supply. Justice Rothstein did not deal at length with Des Chênes, but simply stated that “to the extent that Des Chênes is inconsistent with this reasoning, it should not be followed”.

Both of the issues of applying the GST that the Court dealt with in this case have been litigated in dozens of cases, and the Court’s decision will do little to assist in resolving the issues when they arise in future cases. What the case highlights is the need to make the GST (or any tax base) as comprehensive as possible. The unsolvable problem of distinguishing with any consistency between single or multiple supplies only arises because the GST applies differently to different goods and services. If the GST tax base were comprehensive, the issue would not arise. Also, if the tax base were comprehensive, all the supplies made by the non-profit and public sector entities would be taxable like those made by any other business. There is no convincing policy or administrative reason for not taxing all of their supplies (like transit services); the decision not to tax them on the value of all their supplies is purely political.

VI. MAKING A CONCESSION TO COMMON SENSE

The premise of our introduction, headed “A Failure of Leadership”, is that the courts have a vitally important role to play in the tax policy process and that the Supreme Court has failed to discharge its responsibility of demonstrating to lower courts how this role should be played. Invariably there will be gaps, ambiguities and conflicts in legislation designed to implement legislative policy. The role of the judge is to complement the work of the legislature by ensuring that these gaps are filled, ambiguities settled and conflicts resolved in a way that furthers the objectives of the legislated public policies. In tax cases, the Supreme Court seems to think that the best way to do this is by refusing to engage in a serious analysis of the possible purposes of the legislation it is interpreting or the consequences of its decisions in terms of the furtherance of well-established and well-understood tax principles. Instead, the justices seem to think they can deduce the correct result simply by relying on the

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167 Id., at para. 65.
plain meaning of words or the Court’s statements in prior cases. This encourages lower courts to engage in the same kind of analysis and it encourages counsel before the Court to rely on what they think counts as formal legal analysis and to ignore a serious analysis of the purposes of the legislation and consequences of alternative holdings.

What is striking about the cases for the 2012 docket is that the Court appears so convinced of the determinacy of language as reflected in the plain meaning approach to statutory interpretation that it does not even allude to the purpose of the legislation or the consequences of alternative holdings, let alone take these matters seriously or struggle explicitly with them. Indeed, it does not even refer to common sense considerations in justifying its decisions. Who would think that it would be good common sense to interpret a section of the Act that reflects both sound tax policy and tax expenditure policy (as it relates to part-time farmers) in a way that essentially debilitates the provision? Who would think that it would be good common sense to formulate a test for the residency of trusts for tax purposes that essentially makes the location of their residence voluntary? Or, who would think that in an age in which the largest multinational corporations on the planet have been able to avoid paying much or any tax anywhere in the world on their record profits, it would make good common sense to insist that they be given even greater leeway in structuring their internal transactions to justify their tax-minimizing transfer prices?

The Supreme Court continually insists that it has to adopt a method of interpretation in tax cases that yields predictability and consistency. It is doubtful that the plain meaning approach achieves these ends. Indeed, it is demonstrable that it does not. Nevertheless, even conceding that it might, surely in some cases those values must yield to other values such as furthering the purposes of the public policies underlying the design of the legislation; reaching results that reflect the principles animating a fair, efficient and administrable tax system; and making concessions to brute common sense.