Carrying on the Tradition: Justice Rothstein's Contribution to Canadian Tax Law

Kim Brooks
William Neil Brooks
Carrying on the Tradition: Justice Rothstein’s Contribution to Canadian Tax Law

Neil Brooks and Kim Brooks*

I. A GREAT JUDICIAL FORMALIST

Although constitutional, Charter,¹ and criminal law cases dominate the Supreme Court of Canada’s docket, its Justices must decide cases from across the full legal spectrum. No individual judge could be expected to be expert in the three areas of law that primarily preoccupy the Court alongside all of the other areas of law that are more irregularly before it. As a consequence, individual Justices develop expertise in non-dominant areas of law, usually based upon their experience prior to their judicial appointments. Justice Rothstein took an active part in many of the Court’s most important public law cases, and he also wrote and became widely known for his judgments in intellectual property, competition law, and administrative law. What is perhaps less well known about him, outside of the tax law community, is that he was the Court’s tax judge. He dominated the Court’s tax cases during his tenure. Given the significance of his contributions to tax law, it would probably surprise tax lawyers to learn that tax was only one of many areas of law that he mastered.

Justice Rothstein did not practice tax law. He appears to have had little experience with it before being appointed to the bench. His primary areas of practice were transportation and competition law, and administrative law more generally. However, in a speech he gave to law students on appellate advocacy, he admitted that he was once a plaintiff

---

* Neil Brooks is Professor Emeritus, Osgoode Hall Law School, York University, Toronto; Kim Brooks is Professor, Schulich School of Law, Dalhousie University, Halifax.
in a tax case. He had invested in a limited partnership and made a profit, which was “unusual for me”, and he and his partner (who was a judge at the time) reported the gain as a capital gain. The government reassessed them on the grounds that the gain was business income. He did not say whether he won the case.

Our best guess is that Justice Rothstein developed an interest in and considerable knowledge about tax law while sitting on the Federal Court Trial Division. The year before he was appointed to that Court (he was appointed on June 24, 1992), it lost its jurisdiction over most tax cases. However, the Federal Court Trial Division continued to hear cases in two circumstances. First, if a case had been filed in the Tax Court of Canada prior to 1991, the old procedure applied and the Federal Court Trial Division would hear a trial de novo. Indeed, a case that he heard in 1993 on appeal from the Tax Court of Canada, Neuman v. Minister of National Revenue, was appealed to the Supreme Court of Canada and remains a leading tax case. We discuss it below. Second, because the Tax Court of Canada does not have inherent jurisdiction, taxpayers who appeal against an assessment by the Minister of National Revenue and raise a constitutional or Charter issue appeal to the Federal Court Trial Division, not the Tax Court of Canada. Justice Rothstein’s decision in Del Zotto v. Canada is an example of such a case. It was ultimately appealed to the Supreme Court of Canada. Justice Rothstein wrote 578 judgments in his almost seven years on the Federal Court Trial Division. By our count, 35 of those cases were tax cases.

The Federal Court of Appeal, to which Justice Rothstein was appointed on January 1, 1999, hears appeals from the Tax Court of

---

3 Prior to 1991 the Federal Court Trial Division heard many tax cases since it had concurrent jurisdiction with the Tax Court of Canada to hear taxpayers’ appeals from assessments made by the Minister of National Revenue. It also heard appeals from the Tax Court of Canada by way of trial de novo. After January 1, 1991 tax cases were heard exclusively by the Tax Court of Canada and appeals were made directly to the Federal Court of Appeal. See Colin Campbell, Administration of Income Tax 2011 (Toronto: Carswell, 2011), at 530-31 [hereinafter “Campbell”].
Canada. Over his six years on this Court he rendered judgment in a considerable number of tax cases, over 90 (oral or written) by our count. He wrote 324 judgments in his time on that Court. Thus well over one-quarter of the Federal Court of Appeal cases in which he rendered judgment were tax cases.

The Supreme Court of Canada hears tax cases by leave. Each year it typically grants leave to only two or three tax cases. During Justice Rothstein’s nine-year tenure on the Court, beginning on March 1, 2006, he sat on 24 tax cases. He wrote the majority judgment in 12 of those cases and wrote a dissent in two others. Thus, he was clearly the dominant tax judge during this period. The tax bar certainly regarded him as the Supreme Court’s tax judge. He was frequently invited to be on tax panels and last year he was invited to give the keynote address at the Canadian Tax Foundation’s annual conference.

In this article, we review a selection of Justice Rothstein’s tax judgments with the object of making two observations about his contribution to Canadian tax law. First, Justice Rothstein, who was appointed to the Supreme Court two years after Justice Iacobucci retired, and in many ways stepped into his shoes as the Court’s tax judge, continued Justice Iacobucci’s formalist tradition. That is why we have

---

7 The Tax Court of Canada has two procedures for hearing cases. First, the informal procedure is for cases in which the tax in dispute is less than $25,000. The Court essentially sits as an administrative agency in hearing these cases. Appeals on questions of law can be taken by means of a request for judicial review to the Federal Court of Appeal. Second, the general procedure is for all other cases. The Court sits as a Court in hearing these cases and appeals are taken directly to the Federal Court of Appeal. See Campbell, supra, note 3, at 530-32.

8 Mathen, supra, note 6, at 70, at n. 65.

9 See Ilana Ludwin’s contribution in this volume where she discusses Rothstein J.’s role in granting leave to appeal applications in tax cases.

10 These cases are listed in footnotes 15 and 16 of Ludwin’s article in this volume.

11 Since tax is such a specialized area of law, invariably one or sometimes two judges have or develop a special interest in it and write most of the Courts judgments. For example, from 1979 to 1985, Estey J. wrote many of the tax judgments and between 1993 and 2002 Iacobucci J. wrote most of the tax judgments (a few were co-authored with Bastarache J. or Major J.). On Iacobucci J.’s domination of tax cases during his tenure, see David G. Duff, “Justice Iacobucci and the 'Golden and Straight Metwand' of Canadian Tax Law?” (2007) 57 U.T.L.J. 525 [hereinafter “Duff”].


14 In an article written as part of a collection of articles paying tribute to Iacobucci J., following his retirement from the Supreme Court, David Duff documents the formal approach that U.K. and Canadian courts traditionally took to tax cases. However, he argues that from the late 1970s to the early 1990s the Supreme Court of Canada took a much more purposive or pragmatic
titled this article “Carrying on the Tradition”. The tradition we are referring to is the formalist mode of reasoning that Supreme Court judges usually revert to in tax cases.\footnote{We share a view about Rothstein J.’s approach to judging with Ilana Ludwin. See her article in this volume.}

As for approaches to judicial reasoning, it is common to contrast legal pragmatism with legal formalism. This is not the place to define these terms with any precision or review the debate over which is the most appropriate. Essentially, in interpreting legislation, pragmatic judges consider the consequences of various alternative meanings that might be given to the legislation and choose the one that represents the best policy outcome (in light of the structure of the legislation), while formalist judges purport to derive their decision solely from the text of the legislation and their judgments are written as if their decisions were dictated by a technical legal logic.

Although judicial decision-making represents a continuum between these two positions, Justice Rothstein was closer to the formalist end. In his decisions, he seldom considered, at least explicitly, the consequences of applying the law as he determined it to be in reaching a decision. His basic view was that the policy of the law was the concern of Parliament and not the courts. Put another way, there is no evidence that Justice Rothstein’s decisions were driven by policy concerns or by the consequences of those decisions; instead, in each case he appeared to make a sincere effort to follow the text and doctrine as he understood it.\footnote{That Rothstein J. believes this is his approach is apparent from his testimony on appointment to the Supreme Court of Canada. See Opening Remarks by Mr. Justice Marshall Rothstein to Ad Hoc Committee to Review a Nominee for the Supreme Court of Canada, February 26, 2006, Government of Canada, online: <http://news.gc.ca/web/article-en.do?crtr.sj1D=&mnhd=advSrch&crtr.mnthdVl=&enid=209379&crtr.dpt1D=&crtr.tp1D=&crtr.lc1D=&crtr.kw=tax%2B&crtr.dyStrtVl=&crtr.mnthStrtVl=&crtr.dyndVl=&crtr.mndVl=&crtr.dynVl> (“[j]udges are subject to constraints. I will explain. As neutral arbitrators, we are to interpret and apply the law to the facts of each case”).}

To reveal our theoretical hand, we think judges should be more pragmatic and less formalistic. A more pragmatic approach, in which the judges carefully consider the consequences of their decisions, will lead to more rational, coherent and accessible judicial decision-making; will render the law more predictable; will increase the equity, neutrality and simplicity of the tax system; and will more fully employ the unique skills approach to tax cases. Then under the influence of Iacobucci J., who was appointed to the Supreme Court in 1991, the Court returned to its traditional textualist or formalist approach in tax cases. See Duff, supra, note 11.
and institutional competence of judges.\textsuperscript{17} In Part II of this article, we provide evidence of Justice Rothstein’s formalist approach by examining one case he rendered while serving on the Federal Court Trial Division, Neuman;\textsuperscript{18} and two cases that were decided when he sat on the Federal Court of Appeal, Singleton\textsuperscript{19} and Stewart.\textsuperscript{20} Each of these cases was appealed to the Supreme Court. We also review one case rendered while he was sitting on the Supreme Court, Craig.\textsuperscript{21} Each has become the leading tax case in the area with which it deals. We do not deal with more of Justice Rothstein’s decisions at the Supreme Court because we have discussed several in earlier work and because Ilana Ludwin does so in her article in this volume.\textsuperscript{22}

Part III of this article makes our second point: Justice Rothstein’s tax decisions illustrate why he was so widely admired as a judge. They are well written and technically competent. They are always well organized and free of jargon. They often refer to and engage with the relevant academic literature, they are closely reasoned, and they deal straightforwardly with the arguments, as he sees them, on both sides of the issues. Justice Rothstein clearly mastered the details of the Canadian income tax system. He wrote many leading judgments, but in one area in particular, the application of the General Anti-Avoidance Rule (GAAR), he wrote the first appellate court judgment while serving on the Federal Court of Appeal (the provision was enacted in 1988). This decision guided courts for a number of years. While on the Supreme Court he continued his work in this complex area of law and his judgments at the Supreme Court have laid the foundation for the future development of the rule. Justice Rothstein’s tax jurisprudence is a testament not only to his intelligence and judicial temperament but also a reflection of his

\textsuperscript{17} We have set out our position in an article in which we contrast the generally pragmatic approach taken by former Bowman C.J. of the Tax Court of Canada and the more formalist approach of the judges of the Supreme Court of Canada. See Neil Brooks & Kim Brooks, “Going for the Jugular: Justice Bowman’s Approach to the Craft of Judging” (2010) 58 Can. Tax J. 5 [hereinafter “Brooks & Brooks, ‘Going for the Jugular’”].

\textsuperscript{18} Neuman F.C.T.D., supra, note 4.


legendary work ethic. His decisions are — surprisingly as this may sound, since they are after all tax cases — a joy to read.

II. CONTINUING THE FORMALIST TRADITION

A formalist approach to legal interpretation requires judges to ascribe a meaning to words with careful attention to the text and with little or no attention to the consequences of the interpretive approach taken. Justice Rothstein, like Justice Iacobucci, continued the tradition of judicial formalism in Canadian tax law. In this part of the article, we review five of Justice Rothstein’s cases with an eye to illustrating how Rothstein was reliable and careful in his adherence to and practice of interpretive formalism.

1. Neuman v. Minister of National Revenue

Justice Rothstein’s second tax case on the Federal Court Trial Division, and his first income tax case, was appealed to the Supreme Court of Canada and became a leading tax case. Justice Rothstein’s judgment sanctioned a blatant income-splitting tax avoidance scheme. The Federal Court of Appeal overturned his decision unanimously, striking down the scheme. However, the Supreme Court of Canada, in a judgment written by Justice Iacobucci, unanimously reversed the Federal Court of Appeal and restored Justice Rothstein’s decision for basically the same reasons Rothstein had given. Although the case and its context is somewhat convoluted, we review it in some detail because it reflected the formalist traditions of the Supreme Court in this area and foreshadowed the approach Justice Rothstein would follow in subsequent tax cases.

In income-splitting schemes, high-income taxpayers attempt to arrange to have income earned from their labour or capital, which would otherwise be taxed at their high marginal tax rates, taxed in the hands of a lower-income taxpayer with whom they have a close economic relationship, such as a spouse or child. The scheme used in Neuman is only available to taxpayers who are able to earn their income in a corporation.

---

Although the facts are often more complex, the basic design of the tax scheme is straightforward. The taxpayer, who is usually (but not always) the director of a controlled private corporation, has the corporation issue a separate class of shares to a lower-income spouse or child for a nominal amount. Then, as permitted by the corporation’s articles of incorporation, which invariably confer discretion on the directors to pay dividends of any amount to any class of shareholders, the taxpayer/director pays the desired amount of the corporation’s retained earnings (which would have been earned as a result of the taxpayer’s labour, property, or entrepreneurial skills) to the child or low-income spouse as a dividend. Because income tax rates are progressive, the tax savings can be substantial.

This was the general structure of the arrangements in Neuman. The taxpayer controlled a private corporation that was to be used as a vehicle both to split his income with his spouse and to freeze the value of his estate (which would reduce his tax liability on death). The corporation, to which he appointed his wife the sole director, issued his wife a special class of shares for $99. The next year the corporation paid his wife a dividend on those shares of $14,800, which she promptly loaned interest-free back to the taxpayer. The Canada Revenue Agency (CRA) included this dividend in the taxpayer’s income pursuant to subsection 56(2) of the Income Tax Act (“the Act”):

A payment or transfer of property made pursuant to the direction of, or with the concurrence of, a taxpayer to some other person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person shall be included in computing the taxpayer’s income to the extent that it would be if the payment or transfer had been made to him.24

The CRA argued that their authority for attributing the dividend to the taxpayer came within the precise words of the section. The dividend was (to paraphrase the legislation) “with the concurrence of...a taxpayer [it was made with the taxpayer’s concurrence, the CRA argued, since he was the controlling shareholder of the corporation] to some other person...that the taxpayer desired (to benefit) [his wife]...(and it would have been)...included in...the taxpayer’s income...if the payment [the dividend]...had been made to him”. Even setting aside the fact that the

distributed income had been earned by the taxpayer’s labour and capital and therefore under the most basic tax principles should have been attributed to him for tax purposes, on the clear wording of the subsection the CRA must have assumed this case was a slam dunk.

An important piece of context for understanding Neuman is that three years prior to Neuman, a similar case, McClurg, had been appealed to the Supreme Court. Indeed, the Tax Court of Canada reserved judgment in Neuman until the Supreme Court handed down judgment in McClurg. In McClurg, the CRA was unable to prove that the dividends would have been paid to the taxpayer had they not been paid to the spouse, so the Supreme Court held that subsection 56(2) did not apply to attribute the dividends. The corporation might have simply retained the earnings. In addition to suggesting that subsection 56(2) would not generally apply to the payment of a dividend, Chief Justice Dickson found that the taxpayer’s wife in McClurg had made substantial contributions to the corporation in the form of personal services and guaranteeing loans. Therefore, he wrote, to apply subsection 56(2) “would be contrary to the commercial reality of this particular transaction”. Further, he found that “the payments to Wilma McClurg represented a legitimate quid pro quo and were not simply an attempt to avoid the payment of taxes”. Chief Justice Dickson reasoned that “if a distinction is to be drawn in the application of subsection 56(2) between arm’s length transactions, it should be made between the exercise of a discretionary power to distribute dividends when the non-arm’s length shareholder has made no contribution to the company (in which case subsection 56(2) may be applicable), and those cases in which a legitimate contribution has been made”. In Neuman, the taxpayer’s wife made no contribution to the corporation. Nevertheless, the Tax Court of Canada purported to follow the holding in McClurg and refused to attribute the dividends to the taxpayer. Justice Sarchuk held that the statements of the Supreme Court in McClurg about the significance of the taxpayer’s wife’s contribution to the corporation were obiter dicta.

The CRA appealed the Tax Court’s judgment in Neuman to the Federal Court of Appeal, which affirmed the Tax Court’s decision. The Federal Court of Appeal held that subsection 56(2) applied to attribute the dividends to the taxpayer, stating that “the payments to Wilma McClurg represented a legitimate quid pro quo and were not simply an attempt to avoid the payment of taxes”. Chief Justice Dickson reasoned that “if a distinction is to be drawn in the application of subsection 56(2) between arm’s length transactions, it should be made between the exercise of a discretionary power to distribute dividends when the non-arm’s length shareholder has made no contribution to the company (in which case subsection 56(2) may be applicable), and those cases in which a legitimate contribution has been made”. In Neuman, the taxpayer’s wife made no contribution to the corporation. Nevertheless, the Tax Court of Canada purported to follow the holding in McClurg and refused to attribute the dividends to the taxpayer. Justice Sarchuk held that the statements of the Supreme Court in McClurg about the significance of the taxpayer’s wife’s contribution to the corporation were obiter dicta.

The CRA appealed the Tax Court’s judgment in Neuman to the Federal Court of Appeal, which affirmed the Tax Court’s decision. The Federal Court of Appeal held that subsection 56(2) applied to attribute the dividends to the taxpayer, stating that “the payments to Wilma McClurg represented a legitimate quid pro quo and were not simply an attempt to avoid the payment of taxes”. Chief Justice Dickson reasoned that “if a distinction is to be drawn in the application of subsection 56(2) between arm’s length transactions, it should be made between the exercise of a discretionary power to distribute dividends when the non-arm’s length shareholder has made no contribution to the company (in which case subsection 56(2) may be applicable), and those cases in which a legitimate contribution has been made”. In Neuman, the taxpayer’s wife made no contribution to the corporation. Nevertheless, the Tax Court of Canada purported to follow the holding in McClurg and refused to attribute the dividends to the taxpayer. Justice Sarchuk held that the statements of the Supreme Court in McClurg about the significance of the taxpayer’s wife’s contribution to the corporation were obiter dicta.
Court Trial Division since it wished to restrict the application of *McClurg* to cases where the taxpayer’s wife had made some significant contribution to the corporation.

In the Federal Court Trial Division, Justice Rothstein found that the taxpayer’s holding company “was incorporated [only] for tax planning and income splitting purposes”\(^{30}\). Nevertheless, he held that subsection 56(2) did not apply. Following Chief Justice Dickson in *McClurg*, Rothstein held that the section could not apply since if the dividends had not been paid to the spouse they would not have belonged to the taxpayer but “would remain part of the retained earnings of the company”.\(^{31}\) He also referred to a comment from *McClurg* in which the Chief Justice reasoned that if he were to find that subsection 56(2) applied, “corporate directors potentially could be found liable for the tax consequences of any declaration of dividends made to a third party”.\(^{32}\) Justice Rothstein then wrestled at some length with other statements made in *McClurg* about the transaction’s lack of commercial reality and about whether subsection 56(2) should apply “when the non-arm’s length shareholder has made no contribution to the company”.\(^{33}\) After five pages of carefully parsing Chief Justice Dickson’s analysis, reflecting a solid understanding of the details of the Act, Justice Rothstein ultimately held that these statements were not intended to suggest a separate basis for applying subsection 56(2). He concluded his reasons by noting that “nothing in the scheme of the Income Tax Act as a whole suggests an overall intention to prevent income splitting”.\(^{34}\) In offering this opinion he paraphrased an assertion made by Vern Krishna and Anthony VanDuzer in a case comment on *McClurg* from which he acknowledged deriving assistance.\(^{35}\)

In the Federal Court of Appeal a unanimous court allowed the Minister’s appeal, struck down the tax planning strategy, and held that the lower court judges were bound by the opinion of Chief Justice Dickson that subsection 56(2) would be applicable to a dividend

---

31 *Id.*, at para. 27.
distribution “made in the exercise of a discretionary power...to a non-arm’s length shareholder who...made no contribution to the company”.

On further appeal to the Supreme Court, Justice Rothstein’s decision was affirmed by Justice Iacobucci, writing for a unanimous Court. Justice Iacobucci basically followed Justice Rothstein’s reasoning. He concluded that “unless a reassessed taxpayer had a preexisting entitlement to the dividend income paid to the shareholder of a corporation, the fourth condition [of subsection 56(2)] cannot be satisfied”. Justice Iacobucci also concluded that Chief Justice Dickson’s remarks about whether subsection 56(2) might apply where the recipient of dividend income in a non-arm’s length transaction has not made a legitimate contribution to the corporation were obiter or, if not, were wrong. He reasoned that in corporate law the payment of a dividend is not dependent on a contribution by the shareholder; that whether a contribution was legitimate could not be determined “with any degree of precision or certainty”; and, that such a requirement would be inconsistent with the principle that in the absence of a specific provision taxpayers should be able to arrange their affairs to avoid taxes.

Although this is meant to be a review of Justice Rothstein’s contribution to tax jurisprudence and not necessarily a critique of that jurisprudence itself, five interrelated points might be made about the decision in this case.

First, Justice Rothstein noted at the outset of his judgment that this was a tax avoidance scheme that had no business purpose. In the Supreme Court decision, Justice Iacobucci asserted that “taxpayers are entitled to arrange their affairs for the sole purpose of achieving a favourable position regarding taxation”. Although Justice Rothstein did not use the same phrase in this case (he frequently did in subsequent cases) he clearly assumed it to be true. This might be described as the standard formalist position. In the light of the costs that tax avoidance transactions impose on the tax system, a pragmatic judge would attempt to interpret the Act to minimize tax avoidance opportunities.

Second, in light of their commitment to the text of the legislation, it is surprising that Justices Rothstein and Iacobucci (and Chief Justice

---

38 Id., at paras. 60-63.
39 Id., at para. 63.
Dickson in *McClurg* before them) interpreted subsection 56(2) in a manner contrary to a plain reading of the section. The section does not say that to apply the rule the CRA has to prove that if the payment were not paid to the lower-income recipient it would have been paid to the taxpayer. It merely says that the CRA has to prove that "if the payment...had been made" to the taxpayer instead of the recipient it would be "included in computing the taxpayer’s income". Obviously the dividend in this case would have been taxable income to the taxpayer if it had been paid to him. Reading into the section a requirement that the CRA prove that the taxpayer would otherwise have been entitled to receive the payment is a stretch of the wording and is particularly hard to justify when the transaction is a tax avoidance transaction. Moreover, the Court’s reading of subsection 56(2) essentially makes the section redundant. If a taxpayer is entitled to a payment, but directs it to be paid to someone else, the common law doctrine of constructive receipt, which requires a taxpayer to pay tax on income he or she controls even if it has not been physically received by the taxpayer, would attribute the payment back to the taxpayer for tax purposes.

Third, in support of their reading of the section both Justices Rothstein and Iacobucci referred to a statement by Chief Justice Dickson in *McClurg* to the effect that "[i]f this court were to find otherwise, corporate directors potentially could be found liable for the tax consequences of any declaration of dividends made to a third party".40 This is a misleading overstatement. Subsection 56(2) requires that the payment to which it applies be a "benefit that the taxpayer desired to have conferred on the other person". In this context, a benefit is something received without consideration. In cases where income splitting is not being attempted, the payment of a dividend will be a reasonable return to a shareholder on their capital investment. That is what dividends are supposed to represent.

Fourth, both Justice Rothstein and then Justice Iacobucci41 stated that there is nothing in the scheme of the Act to suggest that income splitting should be prevented. They both referred to the case comment by Krishna and VanDuzer on *McClurg* in support of this proposition.42 Krishna and VanDuzer are wrong on this point. The whole Act is premised on the assumption that income will be taxed to the person who earns it.

42 See Krishna & VanDuzer, *supra*, note 35.
Employment income will be taxed to the employee who earns it, property income will be taxed to the person who owns the property, and business income will be taxed to the business owner. Countless provisions in the Act attempt to ensure this result. Subsection 56(2) is one of those provisions and it should have been interpreted to achieve that result.

Finally, a more pragmatic judge in this case could have followed the suggestion of Chief Justice Dickson in *McClurg*, namely that subsection 56(2) applies unless the shareholder has made a contribution to the corporation that would justify the dividend. This was essentially the position of the unanimous Federal Court of Appeal in this case. To hold otherwise would (and did) predictably lead to blatant and significant tax avoidance. A study done of the tax years around the time of the decision found that the dividend income received by persons under the age of 20 increased five-fold, from $51 million to $255 million. In 1999 the Act was amended so that dividends paid by controlled private corporations and received by related individuals under the age of 18 are be taxed at the top marginal tax rate. In spite of this amendment meant to cover the most egregious cases of income splitting — paying dividends to young children — income splitting with low-income spouses and adult children through controlled private corporations continues unabated. A recent study estimated that the tax revenue lost through such tax avoidance was in the order of $500 million.

2. *Singleton v. Canada*

A few years later, in *Singleton v. Canada*, the Federal Court of Appeal sanctioned a widely used method enabling taxpayers with investments to deduct the interest expense on their home mortgages. Justice Rothstein wrote the judgment in the Court of Appeal for himself.

---

43 In *McClurg* the significant contribution the wife made to the corporation was personal services. As Rothstein J. pointed out it would be odd to justify the payment of a dividend on the grounds that the shareholder had contributed service to the corporation. As he said, “[i]t is a fundamental principle of corporate law that a dividend is a return on capital which attaches to a share, and is in no way dependent on the conduct of a particular shareholder”, *Neuman F.C.T.D.*, supra, note 4, at n. 6. The sensible position would be to require a capital contribution that could justify the payment of the dividend.


46 *Singleton F.C.A.*, supra, note 19.
and Justice McDonald; Justice Linden dissented. The legal context from which Singleton arose is that under the Act if money is borrowed for a personal use, the interest is treated as a personal expense and is not deductible; however, if money is borrowed to earn business or property income the interest is a deductible expense. Although this result would be dictated by the general provisions in and principles underlying the Act, paragraph 20(1)(c) explicitly provides that an interest expense is deductible if paid on “borrowed money used for the purpose of earning income from a business or property”. The courts have held that to determine whether borrowed money is used for a personal purpose or for the purpose of earning income from business or property, the use of the borrowed money should be physically traced.

This physical tracing rule places pressure on a taxpayer’s tax plan, and more specifically on the ordering of the taxpayer’s arrangements. Suppose a taxpayer has a $1 million investment that they wish to retain, but they need $1 million to purchase a personal residence. If the taxpayer borrows the money to purchase the residence, the borrowed money would be used for a personal purpose and therefore the interest would be nondeductible. Hence, tax advisors counsel taxpayers in this situation to sell their investment and use the proceeds to purchase their personal residence. The taxpayer then borrows $1 million to repurchase their investment. In this case, the borrowed money will have been used to earn investment income and the interest will be deductible. If need be, the borrowed money can be secured with a mortgage on the home (the interest will be deductible so long as the borrowed money was not used to purchase the home).

Singleton was a variation of this basic plan. Singleton needed $300,000 to finance the purchase of a home. He did not have a $300,000 portfolio of investments, but he did have $300,000 in his law partnership’s capital account. He withdrew the funds from his capital account, used that cash to purchase a house, and then borrowed $300,000, which he secured with a mortgage on his house, to repay the funds withdrawn from his capital account. These three transactions were completed almost simultaneously. Following these transactions, on the basis that the borrowed money was used directly to finance his law firm, Singleton deducted the interest on the loan as a business expense. The CRA disallowed the deduction on the grounds that the money was used, in economic effect or indirectly, to purchase a home and, therefore, the interest expense was a personal expense.
One way to characterize the issue in this case is to ask whether, in deciding on the use of borrowed money, the court should pragmatically examine the consequences of alternative options for how a decision-maker or taxpayer might determine the use of borrowed money or take a more formalistic approach and be bound by the legal effect of the taxpayer’s individual transactions (in this case the direct use of the borrowed money could be traced to the repayment of the law firm’s capital). In a previous article, we took the position that the sensible pragmatic approach to interest deductibility in the Canadian context requires an appreciation of the role of the physical tracing rule and the acceptance that any rule will lead to equally arbitrary results. 47

In the Tax Court of Canada, Justice Bowman (as he then was) held that the interest was not deductible. 48 Instead of distinguishing between personal and business interest expenses based upon a tracing of the direct use of the borrowed money, he applied the economic reality or the true economic purpose approach in determining the use of the borrowed money. In this case he concluded as follows: “[o]n any realistic view of the matter it could not be said that the money was used for the purpose of making a contribution of capital to the partnership. The fundamental purpose was the purchase of a house and this purpose cannot be altered by the shuffle of cheques that took place on October 27, 1988”. 49

On appeal to the Federal Court of Appeal, Justice Rothstein wrote the majority judgment reversing Justice Bowman and holding that the interest expense was deductible. Although we agree with his decision in result, his reasoning reveals his formalist hand. Justice Rothstein focused on the legal form of the transactions undertaken, casting the issue as whether the various transactions should be treated independently (in which case the borrowed money was clearly used for business purposes) or singularly (in which case the series of transactions resulted in the purchase of a home). Justice Rothstein treated the transactions independently on the grounds that otherwise “an unexplained inconsistency” would arise; namely, if an initial capital investment in the law firm were financed with borrowed funds, the interest would be deductible, but if it were initially financed with cash and then subsequently the cash was withdrawn and used for personal use and the firm refinanced with

49 Id., at para. 12.
borrowed money, the interest would not be deductible. In holding that the transactions should be viewed separately, he also noted that it should not matter whether the transaction took place over the course of an afternoon or some longer period of time. Next, quoting Justice Iacobucci in Neuman, Rothstein held that the fact that “what the appellant did in this case was solely for the purpose of reducing his tax liability” was not a “justification for denying the appellant interest deductibility”. He cited earlier Supreme Court of Canada cases to the effect that legally effective transactions should be respected for tax purposes. Finally, relying on a quote from Professor Krishna’s income tax text, Rothstein noted that “the phrase ‘series of transactions’ appears 41 times [in the Act], its absence from paragraph 20(1)(c) implies that there is no legislative intent to import the series test into that paragraph.”

The Supreme Court in a majority judgment written by Justice Major upheld Justice Rothstein’s decision largely for the same reasons given by him. Justice Rothstein’s approach to resolving tax cases was once again endorsed by the Supreme Court.

In Singleton, Justice Rothstein also gave a policy reason for looking only at the direct use of the borrowed money in deciding whether the related interest expense was for personal or business use; namely, that otherwise two taxpayers who had initially financed their businesses differently would be treated differently for tax purposes even though their asset positions and cash flows were the same. That is to say, taxpayers who initially borrowed money to finance their business and hence had cash available to buy a house would be better off tax-wise than taxpayers who financed their business with cash and then had to borrow to finance a home. He might have then set out the reasons why an economic realities test would be difficult to apply in this context and spelled out the other advantages of a strict tracing rule. Instead, he reiterated the formalistic points that as a general proposition, a taxpayer motivated solely by a tax avoidance purpose should not affect the resolution of the case and that the courts should not look at economic

---

50 Singleton F.C.A., supra, note 19, at para. 49.
51 Id., at para. 50.
52 Id., at para. 60.
53 Id., at para. 61.
54 Id., at para. 63.
substance, but instead the legal substance, of what the taxpayer did.\textsuperscript{55} Finally, as noted above, Rothstein referred to a convention of statutory construction. Since the phrase “series of transactions” is used in many other sections of the Act, but not in paragraph 20(1)(c), he concluded that that paragraph should not be read as applying to a series of transactions but only to the transaction that leads to the direct use of the borrowed money. Resorting to a canon of statutory interpretation to determine the meaning of a legislative provision is a hallmark of formalistic reading. It seems unlikely that any Member of Parliament, Finance Minister, or even someone in the Department of Finance made a conscious decision not to include the phrase “series of transactions” in paragraph 20(1)(c) because they wanted the courts to apply a strict tracing rule in determining whether interest was incurred for a business purpose. Aside from anything else, the predecessor to that paragraph was inserted in the Act in 1923 in order to make it clear that interest was not to be treated as a capital expense, long before the provisions containing the phrase “series of transactions” were added to the Act.

3. \textit{Stewart v. Canada}\textsuperscript{56}

Only a few months after \textit{Singleton}, Justice Rothstein wrote the judgment in another leading case that dealt with a classic tax planning strategy. This time, however, the Supreme Court did not approve of Rothstein’s reasoning or holding. He struck down the taxpayer’s tax planning strategy; the Supreme Court sanctioned it.

The case involved a commonly used scheme for arbitraging the tax system — that is, for making money risk-free through the tax system by deducting an expense from income that would otherwise be taxed at a high rate and having the income earned by the expense taxed at a lower rate. In addition, compounding the arbitrage, the scheme allows the taxpayer to deduct the expense currently and defer paying tax on the income earned by the expense to a future year. The scheme, which can still be used, involves making highly leveraged investments in rental property.

\textsuperscript{55} Celebrating judicial formalism, in her case comment on Rothstein J.’s decision in \textit{Singleton}, Lisa Wong concludes, “\textit{Singleton} may be added to the growing number of cases that recognize that policy making is best left to legislators”. Lisa Wong, “Deductibility of Interest: The Singleton ‘Two Step’” (1999) 47:4 Can. Tax J. 952, at 957.

\textsuperscript{56} \textit{Stewart F.C.A.}, supra, note 20.
In *Stewart*, the taxpayer invested in two condominium projects through a real estate syndicator. The taxpayer made a $1,000 down payment and used borrowed money to pay for the remaining over 99 per cent of the purchase price of the projects. In the sales literature, the syndicator projected that the interest expenses on the borrowed money would far exceed the rental income for many years and that a sale of the property in 10 years would yield a substantial capital gain.

Even if the rental income and the capital gain only equalled the taxpayer’s interest expense (so that in the absence of the tax system the taxpayer would not earn any return), the taxpayer would still make a handsome profit using this scheme through the tax system, for two reasons. First, the excess interest expense each year could be deducted from income taxed at ordinary rates while only one-half of the eventual capital gain would have to be included in income. Second, the interest expense could be deducted each year that it was incurred even though the related (and likely accruing) capital gain would not be taxed until realized, many years later. Even if the capital gain were taxed at ordinary rates, the tax saved on the income sheltered by the excess interest expense each year would be equivalent to an interest-free loan from the government that would not have to be repaid until the capital gain was realized. Everyone realizes that this arbitrage opportunity makes no sense from a policy perspective. Indeed, in a 1997 case, Justice Robertson of the Federal Court of Appeal, in setting aside a similar arrangement, stated: “[i]t is simply unrealistic to expect the Canadian tax system to subsidize the acquisition of rental properties for indefinite periods”.

For whatever reason, over the years the Finance Department has been reluctant to legislate an end to this tax planning strategy. Therefore, in the early 1990s, the CRA began challenging these schemes on the basis that in order to have a source of income, and therefore a deductible expense from that source, a taxpayer had to have a reasonable expectation of making a profit on the investment. In these types of tax shelter cases the taxpayer would almost never have a reasonable expectation of profit because the Act expressly provides that capital gains are not income from property (which generate a profit) and in most of these cases it was the expectation of a large capital gain (which are not “profits”) that made the investments attractive. The interest expenses incurred on the borrowed money inevitably substantially exceed the rental income.

---

In another area of tax law, in order to distinguish between activities that taxpayers were carrying on as a hobby, and hence could not deduct expenses, and activities that taxpayers were carrying on as a business such that all of their business expenses would be deductible, the courts developed the so-called reasonable expectation of profit (REOP) test. If a taxpayer did not have a reasonable expectation of making a profit from an activity, that suggested the activity was a hobby. However, in a leading Supreme Court of Canada case, *Moldowan v. Canada*,58 where this test was applied to assist in determining whether the taxpayer was carrying on horse farming activities only as a hobby, Justice Dickson (as he then was) concluded that “[a]lthough originally disputed, it is now accepted that in order to have a ‘source of income’ the taxpayer must have a profit or a reasonable expectation of profit”.59 Even though this assertion was not necessary for the resolution of *Moldowan*, the CRA latched on to this statement and began aggressively applying the REOP test in tax shelter cases, arguing that unless the investor had a REOP the investor did not have a source of income from the tax shelter investment and thus could not deduct the losses from other income.

Following *Moldowan*, the courts reached inconsistent holdings on the question of whether the REOP test should be applied only in cases where the issue was whether the activity was personal (a hobby) or business, or whether it could also be applied in cases involving tax shelters to deny the taxpayer the deductibility of losses if they had no REOP and hence no source of income from the shelter. *Stewart* was one of these cases.

The trial judge in the Tax Court of Canada accepted the proposition that in order to have a source of income from rental property from which expenses could be claimed, and ultimately a loss could be deducted from other income, the taxpayer had to have a reasonable expectation of profit from the rental income.60 He reviewed the plan of investment prepared by the real estate syndicator showing net rental losses for over 10 years (the plan assumed the taxpayer could deduct these rental losses from other income) and the taxpayer’s intention not to pay down the principal on the outstanding loans on the rental units for a number of years, which would otherwise create a positive cash-flow. The trial judge concluded that as a matter of fact the reasonable expectation of profit test was not satisfied.

59 Id., at 485.
In the Federal Court of Appeal, with a panel that included Justice Rothstein, the taxpayer argued that the REOP test should apply only to distinguish between hobbies and business activities and only when the activity involved an element of personal enjoyment, which investing in rental property did not. In response, Justice Rothstein simply quoted the obiter and highly contested statement referred to above from Justice Dickson in Moldowan — that in order to have a source of income, the taxpayer must have a REOP. In a very short judgment, Rothstein held that in this case there was no reason to override the trial judge’s finding that the taxpayer did not have a REOP and therefore could not deduct his losses on the rental property from other income. In reaching his judgment, Justice Rothstein spent almost no time addressing the view that the REOP should not apply in these types of cases, even though this argument must have been pressed upon him and was likely regarded by the taxpayer as the central issue in the case. A number of highly critical articles in the tax literature argued that the test should not apply in these types of cases and that Justice Bowman in particular, but other judges in the Tax Court of Canada, and even some judges in the Federal Court of Appeal, had refused to apply the REOP test in tax shelter cases. Justice Rothstein’s decision dealt with none of the problems of applying the REOP to investments, such as the difficulty of determining whether the taxpayer had a REOP, how profit is to be determined, whether capital gains should be considered part of the profits for the purposes of applying the test, over what time period taxpayers would have to show they have a REOP, what properties could be grouped in applying the test, and the effect of such a rule on investments in common shares, which are often heavily leveraged and in which the dividend income is almost never expected to exceed the interest expenses.

The Supreme Court reversed Justice Rothstein and the Federal Court of Appeal’s holding that the REOP test did not apply to activities such as investing in property where there was no possibility of personal enjoyment. That test was to be used only for distinguishing between hobbies and business activities. Justices Iacobucci and Bastarache,

---

writing for a unanimous court, exhaustively reviewed the history of the
test, the conflicting case law, the judicial statements and law journal
articles critical of applying the test to property investments, and the
reasons why it should not be applied in such cases. They had no
difficulty finding that Justice Dickson’s comments in Moldowan about
the application of the test in determining whether the taxpayer had a
source of income were obiter and that they ought not to be followed.
Somewhat ironically, since Justice Rothstein would agree with this
sentiment in principle, they found that applying the REOP test to
property investment cases amounted to the kind of judicial law-
making that courts ought not to engage in.62

In this case, Justice Rothstein upheld a bold strategy being used by
the CRA to attempt to prevent tax arbitrage. We refer to the case here not
only because it shows a formalist approach to law, but also because it
illustrates he did not have a pro-taxpayer bias in spite of his frequent
resort to the mantra that generally taxpayers should be free to organize
their affairs to avoid taxes. In this case it would have been easy to hold
for the taxpayer on a number of grounds, as the Supreme Court judgment
illustrates. Further, the REOP test was a crude device for preventing the
type of tax arbitrage used in the case. The issue was an important one and
the subject of numerous critical scholarly articles and contradictory
judicial holdings. The only explanation for his short judgment upholding
the application of the REOP test in tax shelter cases is that he felt bound
by the statement of Justice Dickson in Moldowan that in order to have a
source of income the taxpayer must have a reasonable expectation of profit.63

4. Canada v. Craig64

One of the most interesting tax cases to be heard by the Supreme
Court in recent years, in part because the Court was being asked to
overrule a 1978 precedent and in part because it dealt with a popular tax
shelter, was Canada v. Craig. We review this case in some detail in our
review of the Supreme Court’s 2012 tax cases,65 and review it here only

---

63 Stewart F.C.A., supra, note 20, at para. 7.
64 Craig, supra, note 21.
to illustrate that generally Justice Rothstein continued taking a formalist approach to tax cases even after being elevated to the Supreme Court.

John Craig was a successful lawyer, earning taxable income of well over $600,000 from his practice in the relevant years. He also owned a horse farm on which he incurred a loss for tax purposes of over $200,000 in each of those years. For tax purposes, he offset the losses from his farming business against the profits from his law business and reported his net income. The Minister reassessed him and restricted the deduction of his farm losses from his other income to $8,750, relying upon the restricted farm loss rule. That rule restricts the deduction of farm losses against other income unless a taxpayer’s chief source of income is either (1) farming or (2) a combination of farming and some other source of income. Since the case turned on the correct interpretation of the restricted farm loss rule, subsection 31(1) of the Act, we set it out:

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 taxpayer’s loss, if any, for the year from all farming business...shall be deemed to be [no more than $8,750].66

The interpretive issue in the case was the meaning of the phrase “a combination of farming and some other source of income”. The taxpayer argued that his chief source of income was derived from a combination of farming and his law practice and therefore the restriction in the section should not apply to him. Justice Rothstein agreed. He reasoned (and this was a point made by many jurists and commentators over the years, which he acknowledges) that unless the phrase allows the taxpayer to combine two sources of income then it is redundant since it adds nothing to the first exception to the provision, namely when farming alone is the taxpayer’s chief source of income.67 The premise of Justice Rothstein’s argument is the familiar canon of statutory construction that every word (and phrase) in a statute must be given a distinct meaning.

Justice Rothstein’s decision in Craig features some of the same players as his decision in Stewart. However, unlike his approach in Stewart, in reaching a decision in favour of the taxpayer in Craig, Justice Rothstein had to overrule Moldowan.68 In Moldowan, a case with facts similar to Craig, Justice Dickson (as he then was) restricted the

---

67 Craig, supra, note 21, at paras. 28, 29.
68 Moldowan, supra, note 58.
deduction of the taxpayer’s farming loss by interpreting the combination test in section 31 as applying only if the taxpayer’s other business was a sideline or subordinate source of income. Justice Rothstein justified overruling Moldowan on the grounds that it had read one of the exceptions to the restriction in section 31, namely the combination exception, out of the provision.69 Unlike his treatment of the case in Stewart, in Craig Justice Rothstein took note of the “significant, judicial, academic and other criticism” of Moldowan.70

What is significant is that while taking the drastic step of overruling a prior Supreme Court of Canada case, and deciding the case on a straightforward reading of section 31, Justice Rothstein did not discuss, or even allude to, the purpose of the provision, the history of the section, or the policy consequences of his holding. He assumed the case could be decided by simply examining the words used in the section.

In fact, section 31, as interpreted by Moldowan, plays a vital role in the tax system. That role would have been obvious had the Court examined its history, the several policy discussions of it in government documents over the years, similar sections in other countries, or basic tax principles.71 We laid out those purposes in an earlier article and we will not belabour them here. Our purpose in this review is simply to draw attention to the consistency in Justice Rothstein’s interpretive formalism throughout the trajectory of his judicial career — from the Federal Court Trial Division, to the Federal Court of Appeal, and eventually to the Supreme Court of Canada.

The purpose behind the restricted farm loss rule was of sufficient importance that its interpretation in Craig resulted in the Government announcing in the first budget following that decision that section 31 would be amended. The amendment negates the holding in Craig and adopts the interpretation given to the section in Moldowan. The section now reads that a taxpayer’s farming loss is restricted unless “a taxpayer’s chief source of income...is...farming...or a combination of farming and some other source of income that is a subordinate source of income for the taxpayer”.

---

69 Craig, supra, note 21, at paras. 28, 30 (“the section is clear that two distinct exceptions to the loss deduction limitation can be identified. A judge-made rule that reads one of the exceptions out of the provision is not consistent with the words used by Parliament”).

70 Id., at para. 29.

71 These are reviewed in our comment on this case in Brooks & Brooks, “The Supreme Court’s 2012 Tax Cases”, supra, note 22, at 284-93.
III. LAYING THE FOUNDATIONS FOR CANADA’S GENERAL ANTI-AVOIDANCE RULE

One of the most significant developments in Canadian tax law over the past 30 years was the introduction of the General Anti-Avoidance Rule (GAAR) in 1988.72 The government introduced the rule because the Canadian judiciary was reluctant to set aside tax avoidance transactions using judicially-developed doctrines. The Supreme Court had rejected a business purpose test, which would have allowed the CRA to set aside tax transactions without a business purpose; was unwilling to examine the economic substance of tax planning transactions; and was reluctant to take a purposive approach when interpreting tax legislation, which would have limited the opportunities for tax avoidance.

The GAAR requires three conditions to be satisfied before it applies and permits the CRA to set aside an otherwise legal transaction for tax purposes: (1) the taxpayer derived a tax benefit from the transaction; (2) the taxpayer engaged in the transaction primarily to obtain a tax benefit; and (3) the outcome of the transaction amounts to an abuse or misuse of the tax legislation. The rule by necessity is open-ended and relies upon concepts that had not previously been developed in Canadian tax jurisprudence. Hence there was a good deal of uncertainty about how it would be interpreted and how it would affect tax planning. It was clear from the outset that judges interpreting the rule would have an important balancing role to play in ensuring that abusive tax avoidance schemes were struck down but that valid business arrangements would not be deterred. It took many years for the first cases applying the GAAR to work their way through the courts. Now about 50 GAAR cases have been decided by the Tax Court of Canada; only four have been appealed to the Supreme Court of Canada.

Justice Rothstein played a significant role in interpreting this novel provision. In 2001 in *OSFC Holdings Ltd. v. Canada*,73 he wrote the first comprehensive appellate court judgment on the GAAR. Sitting on the Federal Court of Appeal, he set out the basic methodology to be followed when applying the GAAR and confirmed the far-reaching implications of

---


the provision; namely, that it would override the plain meaning of words
used by Parliament and that in determining whether there has been an
abuse of the Act, courts should resort to the full range of external
sources. The Supreme Court refused leave to appeal in OSFC Holdings.
Three years later, the Supreme Court granted leave to a number of the
other parties that were involved in the same tax avoidance transaction in
Mathew v. Canada.\textsuperscript{74} At the same time, the Supreme Court granted leave
in another major GAAR case, Canada Trustco Mortgage Co. v.
Canada.\textsuperscript{75} The Supreme Court heard and decided both of these cases
together. In these cases, the Supreme Court adopted the basic approach
set out by Justice Rothstein in OSFC Holdings, but disagreed with
aspects of his methodology, as we discuss below. By the time the next
GAAR case reached the Supreme Court, Rothstein had been elevated to
that Court. He heard and dissented (on peculiar grounds, as we discuss
below) in the Court’s third GAAR case, Lipson v. Canada.\textsuperscript{76} Then in
2011 he wrote the judgment for a unanimous Court in the fourth and last
(to date) GAAR case heard by the Supreme Court, Copthorne Holdings
Ltd. v. Canada.\textsuperscript{77} In this case, he returned the Court (somewhat) to the
methodology he set out in his initial OSFC Holdings judgment and
established a firm foundation for the future application and development
of the rule. We review each of these cases highlighting Justice
Rothstein’s central role in developing judicial thinking about the GAAR.

1. OSFC Holdings Ltd. v. Canada\textsuperscript{78}

In this case, a company with large accrued tax losses on a portfolio
of mortgages, which it was unable to use because it was bankrupt,
attempted to transfer them (for a price) to unrelated corporations and
individuals who could use them to reduce their taxable income. The Act
contains a number of specific rules to prevent corporations from selling

[hereinafter “Mathew” cited to S.C.J.].
[hereinafter “Lipson” cited to S.C.J.].
\textsuperscript{78} OSFC Holdings, supra, note 73.
tax losses to unrelated corporations or individuals.\textsuperscript{79} However, the taxpayer in this case devised a scheme to achieve this end that involved using sections of the Act that had entirely different purposes, but that did not run afoul of any of the specific sections in the Act prohibiting it.\textsuperscript{80}

The scheme was straightforward but detailed. Skipping over the details, Standard Trust Corporation (Standard) was a trust company that, because of the economic downturn in the late 1980s and early 1990s, had become insolvent and was holding a mortgage portfolio with over $50 million of accrued losses. A sale of these mortgages would trigger the losses, but the losses would be of no value to Standard since it did not have any taxable income to offset them against. So a scheme was devised that would allow the mortgages to be sold to purchasers who could offset the losses against their taxable income.

There was a section in the Act (subsequently amended) that was designed to prevent a corporate taxpayer from selling property with accrued losses to a related person and realizing the losses on the assets for tax purposes. To illustrate its consequences, suppose that Standard had other income and it wished to trigger the losses on its mortgages so that it could offset those losses against its other income, but Standard did not want to sell the mortgages to an unrelated person. Standard might, in that case, form a wholly owned holding corporation and sell the mortgages to the holding corporation. In this way, it would trigger the loss, but still own the mortgages through the holding corporation.

Subsection 18(13) of the Act was designed to prevent this triggering of losses. The way the section worked was that if a corporation sold property with an accrued loss to a related person, the corporation would not be able to claim the loss, but instead the amount of the loss would be added to the related purchaser’s cost of the property purchased. Hence, the related purchaser would be in the same position as the transferor. That is to say, the related purchaser would be holding property with a large accrued loss that would only be realized when the property was sold to an unrelated person. The provision worked fine when the

\textsuperscript{79} Quite sensibly since if corporations that could not use their losses could arrange to have profitable unrelated corporations use them it would be equivalent to the government refunding the taxes on all corporate business losses. Perhaps the government should refund taxes on all losses as a matter of policy but if the government made that policy decision they presumably would refund the taxes on losses directly.

\textsuperscript{80} Schemes for so-called loss trading, in which a corporation with large losses that it cannot use attempts to sell them to a profitable corporation that can use them, account for a good deal of complex artificial tax planning schemes.
transferee was a corporation, but if the purchaser was a partnership the provision provided an opportunity for tax avoidance.

Under the Act, partnerships are not taxed as separate entities; instead, partnership gains and losses are flowed through to the partners. Hence, if the property with the accrued losses was sold to a related partnership and the partnership sold the property and realized the losses, those losses could be flowed through to individual or corporate partners. These partners might be new partners (that is, partners who bought in after the property was transferred) and unrelated to the transferor corporation. In this way, a corporation’s accrued losses could be claimed by unrelated taxpayers and used to shelter their personal income. This in essence is what happened in OSFC Holdings. Standard Trust, the company with the large accrued losses on its mortgage portfolio, formed a partnership in which it took a 99 per cent interest in return for transferring its mortgage portfolio (with its large accrued losses) to the partnership. It then sold its 99 per cent interest in the partnership to OSFC Holdings Ltd., a profitable mortgage investment business. OSFC Holdings then sold its interest in that partnership to another partnership in which it retained a substantial interest and sold the other interests in that partnership to individual investors, one of whom was Douglas Mathew. Incidentally, most of the new individual partners were tax lawyers who were attempting to use the losses to shelter income from their law firms from tax. When the partnership sold the mortgages with the large accrued losses, for tax purposes those losses flowed through to the individual and corporation partners, including OSFC Holdings and Douglas Mathew and his tax firm colleagues.

In engaging in these transactions, the taxpayer came within the clear wording of subsection 18(13), which provided for the tax consequences when a corporation transfers property with an accrued loss to a related person (in this case a partnership), and subsection 96(1), which provides that gains and losses realized in a partnership flow through to the individual partners (even though they might have joined the partnership during the year). Therefore, if the scheme was to be set aside, it would have to be through the application of the GAAR.

The trial judge in the Tax Court of Canada applied the GAAR to set aside the transaction. The taxpayer appealed to the Federal Court of Canada and in that court Justice Rothstein rendered the first Federal Court of Appeal judgment on the GAAR. He was breaking new ground and he gave a detailed and thoughtful judgment on all the issues relating to the application of the GAAR.
As set out above, for the GAAR to apply the taxpayer has to have received a tax benefit, there must be an avoidance transaction, and the transaction must constitute a misuse or abuse of the Act. The taxpayer in this case did not deny that they had received a tax benefit and that is usually not an issue in GAAR cases. Therefore Justice Rothstein turned his attention, first, to whether there had been an avoidance transaction and, second, to whether there had been an abuse or misuse of the Act.

An avoidance transaction is defined in paragraph 245(3)(b) of the Act as any transaction

…that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

This section raises an interpretive question of how “a series of transactions” should be interpreted and a factual question of whether the impugned transaction was undertaken “primarily for bona fide purposes other than to obtain a tax benefit”.

In OSFC Holdings, there were four transactions. The first three transactions involved transferring the mortgages with accrued losses into a partnership. The fourth transaction involved selling the partnership interests to unrelated investors who would be able to utilize the losses realized when the partnership sold the mortgages and flowed the resulting losses out to them. Since the fourth transaction was not preordained at the time of the first transaction and might not have taken place, the issue was whether all four transactions could be regarded as part of a series, or only the first three.

Justice Rothstein thoroughly reviewed what might be described as the common law meaning of the expression “series of transactions”, particularly as developed in English tax avoidance case law, and the meaning of the phrase as defined in the Act. He concluded that the fourth transaction could be included in the statutory definition of series of transactions since the unrelated purchasers knew of the previous three transactions and took them “into account when deciding to complete the acquisition transaction”.81 This was an important extension of the concept of a series of transactions since the taxpayer in the case and many commentators had argued that a series of transactions should

81 OSFC Holdings, supra, note 73, at para. 38.
only include transactions that were pre-ordained at the time of the initial transaction. If the concept of a series of transactions had been interpreted narrowly, it would have made the GAAR a much less effective instrument for preventing tax avoidance. Justice Rothstein then found that as a matter of fact the primary purpose of all four transactions was to obtain a tax benefit.\textsuperscript{82} He reiterated a number of points essential for a successful GAAR, such as, if any step in the series was inserted primarily to obtain a tax benefit the GAAR applied (even if the series of transactions taken together had primarily a business purpose). Thus, taxpayers could not insert tax motivated transactions into otherwise legitimate business transactions.\textsuperscript{83} He also noted that the person who derives the tax benefit does not have to be the person who undertakes or arranges the transactions.\textsuperscript{84}

The most contentious step in applying the GAAR is determining whether the transaction results in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act, read as a whole. The relevant subsection provides:

\begin{quote}
For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.\textsuperscript{85}
\end{quote}

Before turning to the facts of the case, Justice Rothstein made a number of general comments about this provision. First, he stated that the provision invited two separate inquiries. One, the misuse analysis involves considering the provision that the taxpayer relied upon and “the policy behind it”. Two, the abuse analysis involves considering the avoidance transaction in the light of the provisions of the entire act “read as a whole and the policy behind them”.\textsuperscript{86}

Second, he pointed out that the first question, about a misuse of the provisions, cannot be determined by simply applying the plain meaning of the wording of the provision or otherwise “the GAAR would be rendered meaningless”. For, if the transaction did not come within the

\begin{flushright}
\textsuperscript{82} Id., at paras. 45-58. \\
\textsuperscript{83} Id., at para. 45. \\
\textsuperscript{84} Id., at para. 41. \\
\textsuperscript{85} ITA 1985, supra, note 66, at s. 245(4) as it appeared in 2001. The wording of the section has subsequently changed somewhat. \\
\textsuperscript{86} OSFC Holdings, supra, note 73, at para. 61.
\end{flushright}
plain meaning of the words in the section there would be no need for the application of the GAAR.87 He reiterated this point in noting that determining whether there has been an abuse or misuse “is not an exercise of trying to divine Parliament’s intention by using a purposive analysis where the words used in a statute are ambiguous. Rather it is an invoking of a policy to override the words Parliament has used.”88

Third, he noted that “the approach to determine misuse or abuse has been variously described as purposive, object and spirit, scheme or policy”. However, he preferred to “refer to these terms collectively as policy [sic] of the provisions in question or the Act read as a whole”.89

Fourth, he said that determining “whether there has been a misuse or abuse is a two-stage analytical process. The first stage involves identifying the relevant policy of the provision or of the Act as a whole. The second is the assessment of the facts in determining whether the avoidance transaction constitutes a misuse or abuse having regard to the identified policy”.90

Fifth, he reasoned that, since ascertaining the relevant policy of a provision or the Act is a question of interpretation, it is the judge’s responsibility to make the appropriate determination and the burden of proof does not lie on either party.91 However, in light of the responsibility this imposes on the judge, “the relevant policy [must be] clear and unambiguous”.92

In our view, these observations about the abuse analysis required by the GAAR are exactly correct and their application would make the GAAR an effective instrument for combating aggressive tax avoidance.

Justice Rothstein then held that the transactions in the case before him did not amount to a misuse of the specific provision used to transfer the loss to the partnership, subsection 18(13). That section provided that the accrued loss on the property would not be realized when the property was transferred to a related partnership but would be realized when the partnership sold the property to an unrelated party. In that case, under the partnership rules the loss could be flowed through to the individual

87 Id., at para. 63.
88 Id., at para. 69.
89 Id., at para. 66.
90 Id., at para. 67.
91 Id., at para. 68.
92 Id., at para. 69. See also para. 70 (“[w]here Parliament has not been clear and unambiguous as to its intended policy, the Court cannot make a finding of misuse or abuse, and compliance with the statute must govern”).
partners, who might be unrelated to the original transferor. The transactions in the case were structured to comply with the letter and the purpose of these provisions.

However, after a thorough analysis of the relevant provisions of the Act, Justice Rothstein held that the transactions amounted to an abuse of the Act as a whole. He held that the specific rules in the Act dealing with business losses reflected a general policy against trading or selling business losses to unrelated taxpayers. After a review of the avoidance transactions undertaken, he found that that is precisely what happened in this case. Therefore, the taxpayer was denied the tax benefit claimed in the case.

In this first appellate court judgment involving the GAAR, Justice Rothstein dealt comprehensively with a number of difficult and contentious issues. In spite of the newness of the GAAR and the complexity of the provisions of the Act that were involved, his judgment was a tour de force.

2. Canada Trustco Mortgage Co. v. Canada and Mathew v. Canada

The Supreme Court denied leave to appeal of Rothstein’s judgment in OSFC Holdings. Hence his judgment guided the courts in their interpretation of the GAAR for the next four years. However, the individual investors in the same partnership as OSFC Holdings, which was used to flow out the losses to unrelated parties, were successful in seeking leave to appeal to the Supreme Court. The case, Mathew, was argued and decided at the same time as another leading GAAR case that had been working its way through the judicial system, Canada Trustco. These two cases were the Supreme Court’s first GAAR cases. They were both decided before Justice Rothstein’s appointment to the Court and he did not sit on the Federal Court of Appeal panel that decided either of them. The Supreme Court held unanimously that the GAAR applied in Mathew; that is, it upheld Rothstein’s holding involving the same tax avoidance transaction, but that the GAAR did not apply in Canada Trustco. In part perhaps because they held the GAAR did not apply, the

---

93 Id., at paras. 71-81.
94 Id., at paras. 82-101.
95 Id., at paras. 102-114.
96 Canada Trustco, supra, note 75.
97 Mathew, supra, note 74.
Supreme Court, in a judgment co-authored by Chief Justice McLachlin and Justice Major, set out at length its approach to the GAAR in Canada Trustco and consequently it became the leading case on the GAAR.

Canada Trustco involved a sale-leaseback arrangement that under the plain meaning of the provisions of the Act allowed the taxpayer to, in effect, purchase capital cost allowances that it could use to shelter its taxable income. The corporation that sold the capital cost allowances did not have any Canadian taxable income against which it could offset the allowances. In holding that the GAAR was not applicable, the Court held that none of the transactions defeated the underlying rationale of the particular provisions of the Act that the taxpayer relied upon. That is to say, there was no abusive tax avoidance. In reaching its conclusion the Supreme Court followed most aspects of Justice Rothstein’s approach to the GAAR as set out in OSFC; however, they disagreed with parts of his analysis. Parenthetically, if they had followed his analysis as he had set it out, in particular if they had been willing to infer from the structure of the Act the general policies underlying the Act, they likely would have found that the GAAR applied to this case.

Most significantly, the Supreme Court rejected Justice Rothstein’s approach to establishing a misuse or an abuse. Rothstein had suggested the court should first examine the policy of the particular provisions the avoidance transaction relied upon to see whether those provisions had been misused and then engage in a broad purposive analysis of the structure of the Act as a whole to see whether the overarching policies underlying the Act had been abused. Instead of two distinct inquiries, the Supreme Court stated that the two steps should be “incorporated into a unified, textual, contextual, and purposive approach to interpreting the specific provisions that give rise to the tax benefit”.

Thus the Court suggested there is no distinction between the terms “misuse” and “abuse” as used in the GAAR and that it is only the policy of the specific provisions that should attempt to be determined, not the overarching principles of the Act. However, the Court did add, “[t]he policy analysis proposed as a second step by the Federal Court of Appeal in OSFC is properly incorporated into a unified, textual, contextual, and purposive approach to interpreting the specific provisions that give rise to the tax benefit”.

---

98 Canada Trustco, supra, note 75, at para. 40.
99 Id., at para. 40.
The Court stated that, “[t]he courts cannot search for an overriding policy of the Act that is not based on a unified textual, contextual and purposive interpretation of the specific provisions at issue” for two reasons:

First, such a search is incompatible with the roles of reviewing judges…To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the Income Tax Act would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped.100

Second to search for an overriding policy of the Income Tax Act that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit would run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs.101

On the basis of these observations, the Court proposed a two-step test for determining whether the taxpayer’s transactions have misused or abused the provisions of the Act: “[t]he first task is to interpret the provisions giving rise to the tax benefit and to determine their object, spirit and purpose. The next task is to determine whether the transaction falls within or frustrates this purpose”.102

In Mathew, the Supreme Court struck down the tax avoidance scheme that had been at issue in OSFC Holdings for essentially the same reasons as Justice Rothstein. However, in view of the methodology they suggested in Canada Trustco, instead of finding the scheme was an abuse of the Act as a whole, insofar as it contradicted the general policy of the Act that losses should not be transferable from one arm’s length person to another, they found it was contrary to the object, spirit and purpose of the specific provisions used in the scheme, subsection 18(3) and section 96. They held that “interpreted textually, contextually and purposively, subsection 18(13) and section 96 do not permit arm’s length parties to purchase the tax losses preserved by subsection 18(13) and claim then as their own”.103 In reaching this conclusion they looked at the text of those

100 Id., at para. 41.
101 Id., at para. 42.
102 Id., at para. 44.
103 Id., at para. 58.
provisions, their context ("the general policy of the Income Tax Act is to prohibit the transfer of losses between taxpayers, subject to specific exceptions"), and their purpose (subsection 18(3) denies the deduction of accrued losses on property transferred to a related person because in that case the transferor remains in control of the property; to allow a non-arm's length person to claim the loss (through the use of a partnership) would contradict this purpose). 

In commenting on Justice Rothstein's judgment they wrote:

…[w]hile it reached the correct result, we reject the two-stage method in favour of a unified, textual, contextual and purposive approach to interpretation. This is an abiding principle of interpretation: to determine the intention of the legislator by considering the text, context and purpose of the provisions at issue. This applies to the Income Tax Act and the GAAR as much as any other legislation.

Although perhaps there is not much effective difference between them, we prefer Justice Rothstein's suggested approach to that of the Supreme Court. He was frank in stating that what must be determined is the policy of the specific provisions and the overall policy of the Act. The Supreme Court prefers to refer to the "object, spirit and purpose of the specific provisions". But what are the object, spirit and purpose of a provision if not its policy? Perhaps not surprisingly, Justice Rothstein's approach is consistent with a formalist tradition: in his effort to interpret the GAAR, he took seriously each word in section 245 and attempted to give those words meaning. In many cases in deciding whether the Act has been abused the judges will have to consider the policy judgments that underlie the Act generally as opposed to the policy of a specific provision. This is not, as the Supreme Court suggested, placing the formulation of tax policy in the hands of the judge. It is asking judges to determine what policy judgments underlie the Act, which they must necessarily do, as Justice Rothstein did, by examining the specific provisions in the Act and attempting to determine what broad policy judgments are consistent with those provisions. For example, in Mathew, it seems more correct to say that the court will not allow the specific provision of subsection 18(13) to be used to defeat an obvious policy judgment that underlies the structure of the Act, namely that corporate losses cannot be sold to unrelated parties, than to pretend somehow that

---

104 Id., at para. 49.
105 Id., at para. 54.
106 Id., at para. 42.
subsection 18(13) is being interpreted to achieve that result. In their formulation, the Supreme Court appeared to be confusing interpreting the GAAR with applying it.

3. *Lipson v. Canada*[^107]

In 2009, four years after *Canada Trustco* and *Mathew*, the Supreme Court handed down judgment in its third GAAR case, *Lipson*.[^108] Justice Rothstein had been appointed to the Court in the interim and neither of the judges who authored the judgments in the earlier two GAAR cases sat on the *Lipson* panel: Justice Major had recently retired from the Supreme Court and Chief Justice McLachlin did not participate in the decision. Although the Court applied the GAAR, it was a split decision: Justice LeBel wrote the majority judgment, Justices Binnie and Deschamps dissented on the grounds that the GAAR did not apply because there was no abuse or misuse of the Act, and Justice Rothstein dissented on the grounds that the GAAR did not apply since a specific anti-avoidance provision covered the case.

*Lipson* involved the same type of tax planning as *Singleton*. A taxpayer purchasing a personal residence attempted to arrange his affairs so that interest on the money that had to be borrowed to finance the purchase was deductible. Recall that in *Singleton*, the taxpayer withdrew his capital from his law firm to purchase a residence and then borrowed money to refinance his law firm. In this case, the taxpayer had an incorporated business in which he had a substantial amount of equity, but, unlike Singleton, he could not withdraw the equity from the firm without paying tax on the withdrawn capital as a dividend. Therefore, he adopted a well-known, and one assumes a frequently used in-the-right-circumstance scheme for deducting the interest on the borrowed money.

The taxpayer’s wife borrowed money and purchased the taxpayer’s shares in his corporation from him for their fair market value. The taxpayer used the money his wife paid him to buy the house. Since she borrowed the money in order to earn income from property, dividends that might be paid on the shares she had purchased from him, she could deduct the interest expenses on the borrowed money. However, she had little other income and, in most years, only modest dividends were paid

[^107]: *Lipson*, supra, note 76.

on the shares, hence the excess interest expenses meant she had a large loss on the investment. The husband had transferred the shares to her under a spousal rollover provision of the Act, subsection 73(1), which allowed him to avoid paying tax on the accrued capital gain on the shares. Another section of the Act, subsection 74.1(1), provides that if property is transferred from one spouse to another then any gain or loss realized on the transferred property in the hands of the transferee is attributed back to the transferor.\textsuperscript{109} The wife realized a loss on her investment in the shares equal to the excess of her interest expenses on the borrowed money over any dividends received from the shares. This loss (essentially the interest expense) was attributed to the husband under section 74.1 and he offset it against his other income. Thus, the taxpayer was effectively able to deduct interest on money borrowed to purchase a home. This of course is the same result as \textit{Singleton}, except in \textit{Singleton} the equity that was used to purchase the home came out of after-tax income, while in \textit{Lipson} tax was not paid on the equity sold to the wife because the taxpayer had deferred tax on the gain accrued on the shares by using the subsection 73(1) spousal rollover.

All parties agreed that Lipson had obtained a tax benefit and that the scheme was an avoidance transaction. The central issue on the appeal of the reassessment was whether or not allowing Lipson an interest deduction amounted to a misuse or abuse of the relevant provisions within the meaning of subsection 245(4). The majority of the Supreme Court, in a judgment written by Justice LeBel, held that the tax consequences that resulted from the transactions were not consistent with the underlying purpose of subsection 74.1(1), the spousal attribution rule.

The purpose of the rule, he wrote, “is to prevent spouses…from reducing tax by taking advantage of their non-arm’s length status when transferring property between themselves” by splitting their income.\textsuperscript{110} In \textit{Lipson}, the taxpayer used the provision to deduct an expense that if he had incurred it himself would have been a personal expense. That is to say, the taxpayer used a provision designed to prevent tax avoidance in a way that allowed him to reduce his taxes. Therefore, the tax-reducing transaction “qualifies as abusive tax avoidance”.\textsuperscript{111} Justices Binnie and Deschamps wrote a strong dissent holding that the Crown had “failed to

\textsuperscript{109} This section does not apply if the property is sold at fair market value provided the transferor elects out of the spousal rollover rule in subs. 73(1), which the husband did not do in this case, see subs. 74.5(1).

\textsuperscript{110} \textit{Lipson}, supra, note 76, at para. 32.

\textsuperscript{111} \textit{Id.}, at para. 42.
identify a specific policy shown to be frustrated by the appellant’s plan”. The difference of opinion between the majority and these dissenters need not concern us here, but what is of interest is that in his first GAAR case on the Supreme Court, and one in which the application of the GAAR was clearly contested among the judges, Justice Rothstein dissented but refused to join with either group of his colleagues.

Justice Rothstein dissented on the grounds that the GAAR was not applicable because a specific anti-avoidance rule in the Act covered the case. The anti-avoidance rule that he held applied provides that the attribution rules (for example, subsection 74.1(1)) do not apply to “a transfer...of property where it may reasonably be concluded that one of the main reasons for the transfer...was to reduce the amount of tax that would...be payable...on the income...from the property”.

Justice Rothstein held that this anti-avoidance provision, subsection 74.5(11), applied to the circumstances of the taxpayer since “one of the main reasons for the transfer of the shares was to reduce the amount of tax that would be payable on the dividend income derived from the shares”. He justified this on the basis that if the taxpayer were to reduce the tax payable on his other income with the transferred excess interest expense, the tax payable on the dividends would have to be reduced to zero.

Further, since that section applied, the Minister could not invoke the GAAR since the GAAR was “only intended to operate as a provision of last resort”. He held that the “[m]inister’s failure to invoke s. 74.5(11) is fatal to his reassessment in respect of s. 74.1(1)” and, therefore, he would have allowed the appeal.

Justice Rothstein’s dissent is odd. Both the Minister and the taxpayer agreed that subsection 74.5(11) did not apply to the case and they did not argue the point. The issue was not dealt with in the courts below. Justice LeBel, writing for the majority, thought it was improper to consider it since “its interpretation and application were not issues litigated by the parties” and further he doubted “that the provision would have properly addressed the complex series of transactions before this Court”.

Justices Binnie and Deschamps in their dissent refused to consider the

112 Id., at para. 67.
113 ITA 1985, supra, note 66, s. 74.5(11).
114 Lipson, supra, note 76, at para. 103.
115 Id., at para. 120.
116 Id., at para. 119.
117 Id., at para. 114.
118 Id., at para. 46.
section since it was not argued and noted in particular that even the factual basis upon which the section might apply — “that one of the main reasons in the transfer...was to reduce the amount of tax that would...be payable” — was not alleged or proven.119

Further, commentators have always assumed that the purpose of subsection 74.5(11) is to prevent transactions designed to produce reverse attribution from a high-income to a lower-income spouse. For example, a lower-income spouse might invoke the attribution rules by guaranteeing a loan that a third party makes to the high-income spouse. Under subsection 74.5(7), any income earned on the borrowed funds might be attributed to the low-income spouse. This transaction falls with the clear wording of subsection 74.5(11). Although Justice Rothstein carefully and analytically deals with all the arguments that were made against his interpretation, at its best his reasoning might be described as highly technical. But particularly given that his interpretation of subsection 74.5(11) was so contestable, and contested, it seems strange that Rothstein would not have used the occasion to continue to develop his thoughts on the interpretation and application of the GAAR.

4. **Copthorne Holdings Ltd. v. Canada**120

*Lipson* caused a good deal of concern in the tax community, particularly since the Court was split and there was speculation that the Court might be prepared to either consolidate the effect of the GAAR or scuttle it. Two years later, *Copthorne Holdings* became the Court’s fourth (and now the leading) case on the GAAR. Justice Rothstein wrote the judgment upholding the application of the GAAR in the case and his judgment was supported unanimously by the Court.121 His judgment is a model of the judicial craft. It is logically and tightly organized, clear and concise, and dealt comprehensively with all of the outstanding issues relating to the application of the GAAR.

The facts of the case are not important, but basically the tax avoidance scheme involved attempting to increase a subsidiary corporation’s paid-up capital so that more of its retained earnings could

119  *Id.*, at para. 61.
120  *Copthorne Holdings, supra*, note 77.
be paid to a parent corporation as a tax-free return of capital (which might result in a capital gain) instead of as a dividend. Under the Act, a corporation’s paid-up capital represents the equity capital that the shareholders have invested in the corporation. This amount can be returned to the shareholder as a non-taxable return of capital. In a distribution to shareholders, any amount paid in excess of a return of capital is treated as a dividend. Thus, the concept of paid-up capital is crucial in the taxation of corporate distributions since, to the extent it is increased, a corporation can make a larger return of capital to the shareholders and avoid having the distribution treated as a dividend.

Generally, under the Act, if corporations engage in a horizontal amalgamation their paid-up capitals are aggregated. However, if they engage in a vertical amalgamation, the paid-up-capital of the subsidiary corporation is cancelled. To illustrate the sense of this result, and to see how the issue in Copthorne arose, assume a parent corporation establishes two “sister” subsidiaries and capitalizes each with an equity contribution of say $100. In that case each subsidiary corporation would be able to pay $100 to the parent as a return of capital. If the two subsidiary corporations amalgamate by means of a horizontal amalgamation, the paid-up capital of the new amalgamated corporation will be $200, namely the paid-up capital of each of the subsidiary corporations, since that is the amount the parent corporation contributed to the corporations. But assume a parent corporation establishes one subsidiary and capitalizes it with a payment of $100. Now assume that subsidiary corporation establishes its own sub-subsidiary and capitalizes it with a payment of $100. The paid-up capital of the subsidiary and the sub-subsidiary will each be $100. The sub-subsidiary will be able to pay $100 to the subsidiary as a return of capital and the subsidiary will be able to pay the parent corporation $100 as a return of capital. Now assume that the sub-subsidiary and subsidiary engage in a vertical amalgamation. In that case under the Act the paid-up capital of the amalgamated subsidiary will remain at $100. The reason for this is obvious. Otherwise a corporation that capitalizes its subsidiary with a paid-up capital of $100 could increase the paid-up capital that could be returned to it by simply forming a chain of subsidiaries and capitalizing each with the same $100 as it moves down the chain. If there were five subsidiaries in the chain and each capitalized the lower subsidiary with the same $100 if they were all vertically amalgamated the paid-up capital of the subsidiary would be $500 even though the parent only capitalized it with $100. Hence the Act provides that on a vertical amalgamation the
paid-up capital of the subsidiaries are not aggregated but instead the 
paid-up capital of the subsidiaries are cancelled.

In *Copthorne* (stylizing the facts slightly) a nonresident corporation 
owned a Canadian subsidiary, which in turn owned a sub-subsidiary. The 
nonresident wished to redeem the shares of the Canadian corporation and 
have the amount paid to it treated as a return of capital. If it had 
amalgamated its Canadian subsidiary and its sub-subsidiary by means of 
a vertical amalgamation, the paid-up capital of the sub-subsidiary would 
have been cancelled. So, instead of proceeding in this way, the subsidiary 
sold the shares of the sub-subsidiary to the nonresident parent, hence the 
Canadian subsidiary and its sub-subsidiary became “sister” corporations. 
They horizontally amalgamated next. Then, upon redemption of the 
shares of the new amalgamated corporation, the nonresident corporation 
argued that since the two subsidiary corporations had engaged in 
horizontal amalgamation their paid-up capitals should be aggregated. 
Hence the amount paid for the redemption of shares, which did not 
exceed this aggregated amount, should be treated as a return of capital.

The technical provisions of the Act were complied with, and yet, the 
result was that if the transactions were allowed to stand corporations 
could artificially increase the paid-up capital of their subsidiaries simply 
by capitalizing a chain of corporations and then through a series of 
transactions have them enter into horizontal amalgamations.

Justice Rothstein begins his judgment with five paragraphs that 
provide a general description of the issue and how it arose. He gives the 
description concisely and straightforwardly, so that the issue can be 
understood intuitively. The character of his judgments is part of his 
genius as a judge. He does it much better than we did above. Following a 
detailed statement of the facts and the proceedings in the lower courts, he 
methodically goes through each step required in applying the GAAR.

First, he held that there was a tax benefit. He compared the tax paid 
on the redemption of the shares after the horizontal amalgamation with 
the tax that would have been paid if the more straightforward vertical 
amalgamation had been undertaken.122

Second, he found that there was a series of transactions that gave rise 
to the tax benefit and that these transactions were not entered into 
primarily for a *bona fide* non-tax purpose. In making this finding he had 
to find that the eventual redemption of the shares should be included in 
the series of transactions that gave rise to the tax benefit (along with the

---

122 *Copthorne Holdings*, *supra*, note 77, at paras. 34-38.
sale of the subsidiary shares to the nonresident parent corporation and the subsequent horizontal amalgamation of the subsidiary and the Canadian corporation). He followed Canada Trustco in holding that a transaction would be part of the series if it was done “in relation to” or “because of” the series. The statutory definition of “series of transactions” reads: “the series shall be deemed to include any related transactions or events completed in contemplation of the series”. The taxpayer, supported by some commentators, argued that this definition should be read narrowly as including only transactions that were initially contemplated as part of the series. However, based in part on statements by the Supreme Court in Canada Trustco and, he noted, on the interpretation of the phrase as it was applied in OSFC Holdings, he held that a broader interpretation that applied both prospectively and retrospectively accords with the Parliamentary purpose. Having given this meaning to the phrase “series of transactions” he had little difficulty finding that “the prior sale and amalgamation…including the redemption transaction, resulted in a tax benefit”.

Finally, he had to decide whether the avoidance transaction was abusive. He began his analysis, as he did in OSFC Holdings, by setting out some general propositions relating to the interpretation and application of the GAAR. Setting out the premises from which he proceeds not only makes his judgments more interesting to read, but it makes them more transparent. We think it is a good practice even though we disagree with a couple of his premises, as we mention below. First, he offered his opinion that the terms abuse and misuse in applying the GAAR should not be taken to imply that there is any “moral opprobrium” when taxpayers attempt to minimize their tax liabilities by “utilizing the provisions of the Income Tax Act in a creative way”. Such an implication he suggests “would be inappropriate”. It is not clear to us why Justice Rothstein would offer this opinion. Presumably the morality of the conduct in question should be irrelevant to the decision.

Second, he affirmed that “[t]axpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability.” The proposition is perfectly general and perfectly meaningless. Of course

---

123 Id., at para. 46.
124 ITA 1985, supra, note 66, at s. 248(10).
125 Copthorne Holdings, supra, note 77, at paras. 55-56.
126 Id., at para. 58.
127 Id., at para. 65.
128 Id., at para. 65.
taxpayers are entitled to order their affairs to minimize their taxes. The only interesting question is: have they done so? The general proposition does not help resolve that question.

Third, noting that with the enactment of the GAAR “Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision...relied upon by the taxpayer”129 Justice Rothstein cautions that “[t]he GAAR does create some uncertainty for taxpayers” and “the court must approach a GAAR decision cautiously”. He also quotes a number of cautionary warnings from Canada Trustco: that the GARR was enacted “as a provision of last resort”; “Parliament must...be taken to seek consistency, predictability and fairness in tax law”; and “the GAAR can only be applied...when the abusive nature of the transaction is clear”.130 It is not clear why the Supreme Court, including Justice Rothstein, is so wary of the GAAR. It is a direction by Parliament to the courts, like all pieces of legislation. It is not obvious why the courts should be any more cautious or concerned about consistency and fairness in applying the GAAR than they should be in applying any other tax provision. Nor would the suggested higher standard of clarity in determining the abusive nature of a transaction seem to be required. This is particularly so since before they get to the abuse analysis in a GAAR case a judge would have already determined that the transaction or series of transactions resulted in a “tax benefit [that could not]...reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit”.131 Thus, even if they get it wrong at this stage of the analysis and hold a transaction to be abusive when it is not, they will not have affected a transaction that was engaged in for a bona fide business purpose. Indeed, in the light of the serious costs that tax avoidance imposes on the tax system the default decision-making rule should perhaps run in the other direction. Additionally, it does not appear that the application of the GAAR gives rise to much uncertainty. In Copthorne, for example, every judge who heard the case, 13 separate judges, held that GAAR applied.

Fourth, reiterating a point the Supreme Court made in Lipson, Justice Rothstein stated that in considering whether a transaction frustrates the purpose of a particular provision, if it is part of a series of transactions

129 Id., at para. 66.
130 Id., at paras. 66-68.
131 ITA 1985, supra, note 66, at s. 245(3)(b).
then it must be considered “in the context of the series of which it is a part and the overall result that is achieved”.

Fifth, accepting the point made in Canada Trustco, he noted that there was no distinction between abuse and misuse but only “a single unified approach”.

Sixth, Justice Rothstein reiterated the two-step approach that had been adopted in Canada Trustco in determining whether a transaction (or series of transactions) amounted to an abuse or misuse of the Act. First, a court “must determine the ‘object, spirit or purpose of the provisions…that are relied on for tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids’”.

Second, “a court must consider whether the transaction falls within or frustrates the identified purpose”. In stating the first step he quoted from Canada Trustco, presumably since they were so critical of his suggestion in OSFC Holdings that the court should consider both the policy of the provisions and the policy of the Act itself. Yet, as noted, it is hard to know what “object, spirit or purpose” of a provision refers to if not the policy underlying it. And, in many cases, it will be a policy judgment that is apparent by examining other provisions or the structure of the Act that is being frustrated not the spirit (or policy) of the specific provisions that the taxpayer relied upon. Although Justice Rothstein does not press the point, he does refer to a quote from Krishna’s income tax text that basically makes the point he made in OSFC Holdings: “[t]he object, spirit or purpose of the provisions has been referred to (by Krishna) as the ‘legislative rationale that underlies specific or interrelated provisions in the Act’.”

Having set out these preliminary points, Rothstein then undertook a careful, comprehensive review applying the proposed analysis to the transactions in the case. He suggested that in this case it was subsection 87(3) that might have been abused. This is the section that provides that on a horizontal amalgamation the paid-up capital of the predecessor corporations are aggregated, but that in a vertical amalgamation the paid-up capital of the subsidiary corporation is cancelled. Following the formula provided in Canada Trustco, he then examined at length under separate headings the “text, context and

132 Copthorne Holdings, supra, note 77, at para. 71.
133 Id., at para. 73.
134 Id., at para. 68.
135 Id., at para. 71.
136 Id., at para. 69.
purpose” of subsection 87(3). He broke the “context” section down into five separate sub-headings. Following this detailed analysis, he concluded that the purpose of the concept of paid-up capital is to allow for the non-taxable return of the shareholders’ (tax-paid) capital (and any amount paid to shareholders in excess of that should be taxed as a dividend). He also determined that the purpose of cancelling the paid-up capital of the subsidiary corporation in a vertical amalgamation is to prevent corporations from creating additional paid-up capital that could be returned to shareholders simply by passing the capital contributed by shareholders down through a chain of subsidiaries and then vertically amalgamating them. It is a thorough analysis.

In the second step of the analysis, he held that the transactions engaged in by the taxpayer amounted to an abuse of these provisions. In particular, the sale of the Canadian subsidiary to the nonresident parent corporation (so that a horizontal amalgamation could take place between the Canadian subsidiary and its Canadian parent instead of a vertical amalgamation) circumvented the requirement in subsection 87(3) that on a vertical amalgamation the paid-up capital of the subsidiary corporation is cancelled in order to preserve the purpose of the concept of paid-up capital.  

Copthorne had reminded the Court in its argument that, based on the admonition in Canada Trustco, it could not rest its reasoning about whether there had been an abuse on a general policy purporting to underlie the Act. However, Justice Rothstein replied that “the tax purpose identified in these reasons is based upon an examination of the PUC (paid-up capital) sections of the Act, not a broadly stated policy”. But of course presumably that is what Rothstein meant when he talked about the overriding policy of the Act in OSFC Holdings; namely, one that could be inferred from the specific provisions and structure of the Act.

Although Justice Rothstein mentioned at the outset of his analysis that, as stated in Canada Trustco, with respect to determining an abuse of the Act the burden was on the Crown to explain the policy that was abused and the benefit of the doubt should go to the taxpayer, in fact Rothstein did not review the evidence that the Crown had presented or address whether the burden had been met. He proceeded as judges generally do in determining the law and its application; he simply addressed the issue as if it was his responsibility to reach the appropriate decision.

137 Id., at paras. 123-127.
138 Id., at para. 118.
Under Justice Rothstein’s influence, the Court has reached an appropriate interpretation of the GAAR. Although some details remain to be worked out, the Court has clearly signalled that the GAAR has an important role to play in addressing abusive tax avoidance and has provided effective tools of analysis for achieving that result. The Supreme Court has not felt the need to grant any leaves to appeal in GAAR cases since Copthorne.

IV. CONCLUSION

One of the most enduring debates in the legal literature is over the role of the courts in interpreting legislation. The formalists distinguish between legal reasoning and normative or policy considerations; they assume there is a sharp separation between making the law and applying it; and they maintain that what the law says is entirely distinct from what it ought to say. Pragmatists do not see these sharp distinctions. In interpreting legislation they don’t think judges have the authority to determine the law according to their own ideas regarding the best policy outcome, but that they have the responsibility to achieve an outcome that accords with common sense and the principles that underlie the legislation being interpreted. In tax cases, the Supreme Court has generally clung tenaciously to the formalistic plain-meaning approach to statutory interpretation in spite of frequently suggesting the correct approach is a “textual, contextual, and purposive” approach. Justice Rothstein continued in this tradition. This is regrettable, in our view, given that his crisply written, carefully crafted and tightly reasoned judgments might have been able to persuade the Court that the gaps and ambiguities in tax legislation should be resolved by the courts in a way that completes the work of Parliament, increases the fairness of tax law and its moral acceptability, and generally improves the quality of the law. Despite our differences in general approach, however, a review of Justice Rothstein’s contributions to tax law reveals him to have made a considerable contribution. This is perhaps no more true than in his judgments in the GAAR cases, which demonstrate he had a sure grasp of the principles and policies that animate the Act. He has set the courts on solid ground and leaves a significant legacy for the Supreme Court’s next tax judge.