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TAKING THE GAAR TOO FAR: AN ANALYSIS OF *MCNICHOL* V. *THE QUEEN*

TIMOTHY R. HUGHES†

The decision of the Tax Court of Canada in *McNichol* v. *The Queen*[1] represents the first instance in which the General Anti-Avoidance Rule (the "GAAR"), in section 245 of the *Income Tax Act*,[2] has been judicially applied. The impugned transaction was a classic example of dividend or "surplus" stripping, which involves the removal of tax paid net profit from a corporation as capital rather than by a distribution of dividends. There are specific anti-avoidance measures within the *Act* which purport to deal with surplus stripping transactions. The Court, however, chose not to utilize such purpose-built provisions, but relied instead on the expansive ambit of the GAAR.

This note will comment on the *McNichol* decision by first providing a brief outline of the facts, undertaking an analysis of the transaction under the specific subsection 84(2) anti-avoidance provision and, finally commenting on the Court's application of the GAAR. The conclusion of this note is that the presence of specific anti-avoidance rules should preclude the application of the GAAR. This view finds support in previous decisions of the Supreme Court of Canada, and is consistent with the clear intent of Parliament. In the result, the Court's decision to disallow the transaction in *McNichol* is appropriate, but should have been achieved pursuant to subsection 84(2), a provision particular to the type of transaction at issue, instead of under the section 245 GAAR.

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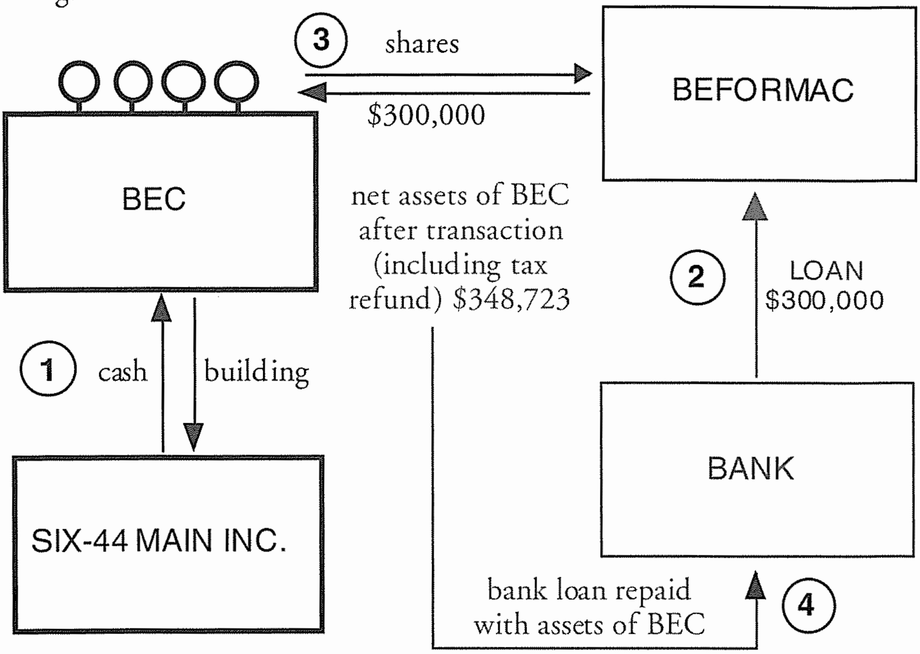
[1] [1997] 2 C.T.C. 2088.

[2] R.S.C. 1985, c.1 (5th Supp.) [hereinafter the *Act*]. All statutory references in this paper are to the *Act*.

I. THE FACTS

In the *McNichol* case, the appellants were the only shareholders of Bec Holding Corporation ("Bec"). Bec held an office building as its sole asset, portions of which were leased to a law firm in which the appellants were partners. When their relationship within the firm began to sour, and the firm changed premises, the appellants took measures to dissolve Bec and distribute profits. With the aid of a professional tax adviser, a series of steps were carried out to effect this result. The complete transaction is illustrated in Figure 1.

Fig. 1



First, the building owned by Bec was sold to Six-44 Main Inc., the owner of the new building in which the law firm was to be located in late January 1989 (Step 1 in Fig. 1). After the sale, the only asset held by Bec was cash, and there was no intention on the part of the estranged partners to continue to operate the corporation as a going concern. His Honour Judge Bonner found

> ...that the completion in January of 1989 of the sale of Bec's building marked the end of its rental business. By

> then relationships among the appellants had deteriorated to such an extent that there was no prospect whatever that Bec would commence any new business.[3]

In distributing the assets of Bec, the taxpayers could have caused the corporation to declare dividends. Such dividends would have been taxable in the hands of the taxpayers at their full marginal rates. As a corollary, this method of distribution would also have generated a dividend tax refund for Bec under section 129. The taxpayers chose, however, to attempt to secure the assets of the company as capital through a sale of all Bec shares to Beformac Holdings Limited ("Beformac") (Step 2 in Fig. 1). Forestall, the president of Beformac, was a client of one of the taxpayers.

Beformac could not afford to make the purchase with existing funds, so financing from the Canadian Imperial Bank of Commerce (the "Bank") was obtained. The loan was secured with the assets of Bec by appointing Forestall as the sole director and officer of Bec and furnishing him with the company seal immediately before the closing of the transaction. Although the bank manager described this as "somewhat unusual", he felt that the Bank's position was sufficiently secure and recommended that the funds be advanced.[4] The sale of the shares was completed on March 29, 1989 (Step 3 in Fig. 1), and the loan was repaid with the assets of Bec after amalgamation with Beformac on April 21, 1989 (Step 4 in Fig. 1) .

The taxpayers received $75,000 each as a result of the transaction and declared the money as income resulting from a disposition of capital property on their respective 1989 tax returns. By utilizing the then applicable subsection 110.6(3) capital gains exemption, two of the taxpayers effectively sheltered the entire amount of the money derived as a result of the transaction, and the others paid only a nominal amount of tax. Revenue Canada reassessed their returns, declaring the amount received as a taxable dividend. The GAAR was used as the only tool of reassessment. The taxpayers appealed to the Tax Court of Canada, where the Minister invoked subsection 84(2) and section 84.1 as additional bases for

[3] *Supra* note 1 at 2094.
[4] *Ibid.*

taxing the amounts received in an amendment to the Reply filed in the proceedings. This note will not address the Court's approach to the section 84.1 argument put forward by the Minister, as it was dealt with in a conventional and, with respect, appropriate fashion. The subsection 84(2) argument requires critical discussion, and will be considered in the following section.

II. THE SUBSECTION 84(2) ANALYSIS

It is my position that the GAAR should not have been applied in the *McNichol* case. There are a sufficient number of specific provisions in the *Act* to deal with surplus stripping schemes two of which are section 84.1 and subsection 84(2), the sections invoked as additional reasons for denying the transactions in Revenue Canada's amendments to the Reply filed in the *McNichol* proceedings. The use of the rule was unnecessarily detrimental to the taxpayers involved, and is likely to have far-reaching policy ramifications to its future application.

With respect, the only provision which should have been used on these facts is subsection 84(2). The Minister realized the applicability of this subsection only after proceedings were under way; Judge Bonner, however, rejected it outright. Perhaps Revenue Canada's approach can be attributed to a desire to apply the new GAAR rule to a "can't lose" situation. The Court's decision, as will be explained, is difficult to reconcile as it is not supported by precedent or policy. Subsection 84(2) reads as follows:

> Where funds or property of a corporation resident in Canada have at any time after March 31, 1977 been distributed or otherwise appropriated in any manner whatsoever to or for the benefit of shareholders of any class of shares in its capital stock, on the winding-up, discontinuance or reorganization of its business, the corporation shall be deemed to have paid at that time a dividend on the shares of that class equal to the amount, if any, by which,
>
> (a) the amount or value of the funds or property distributed or appropriated, as the case may be, exceeds
>
> (b) the amount, if any, by which the paid-up capital

> in respect of the shares of that class is reduced on the distribution or appropriation, as the case may be,
>
> and a dividend shall be deemed to have been received at that time by each person who held any of the issued shares at that time equal to that proportion of the amount of the excess that the number of the shares of that class held by the person immediately before that time is of the number of the issued shares of that class outstanding immediately before that time.

It can hardly be said that the normative transaction to which the situation in *McNichol* should be equated is not the "winding-up" or "discontinuance" of Bec. As discussed above, the only asset held by the company was cash, and none of the shareholders had any intention of continuing to operate the business. A transfer of cash effected through a surplus stripping transaction such as that found in *McNichol* is captured within the ambit of subsection 84(2) as "funds...distributed or otherwise appropriated in any manner whatsoever." The effect of subsection 84(2) on such transactions is best explained by the Supreme Court of Canada in *Smythe* v. *M.N.R.*[5]

Judge Bonner, however, dismissed the *Smythe* case out of hand, notwithstanding the similarity between its facts and the fact situation in *McNichol.* In the judgment he states, "[i]t is not necessary to delve into the complexities of the transaction in *Smythe.*"[6] Figure 2 outlines the "complexities" of the transaction in that case which, as can be seen, are virtually on all fours with the series of transactions in *McNichol.*

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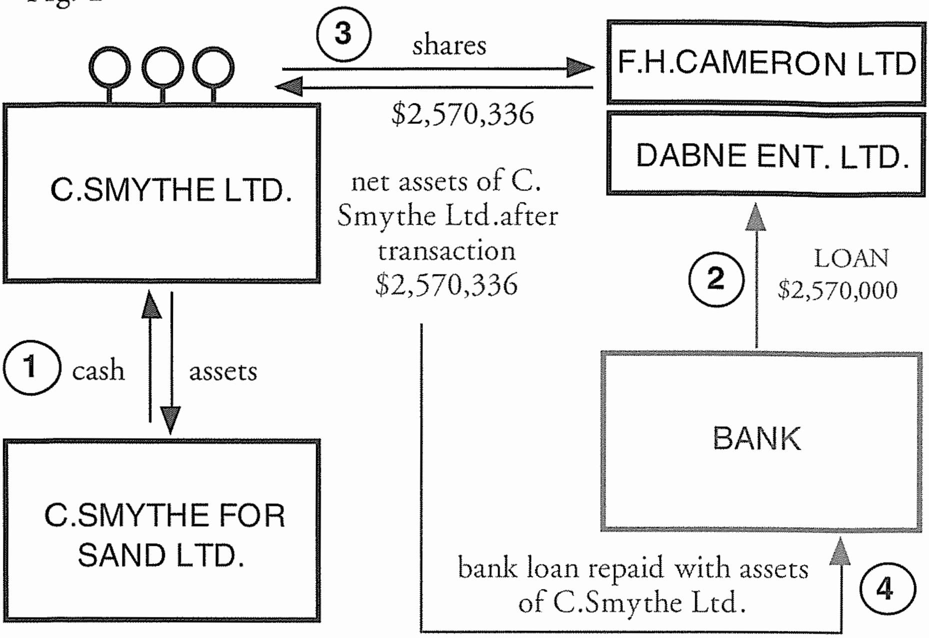
[5] [1969] C.T.C. 558 (S.C.C.).
[6] *Supra* note 1 at 2099-2100.

Fig. 2



The taxpayers in *Smythe* were the three shareholders of C. Smythe Ltd. who, for the tax reasons discussed above, wished to effect a distribution of income from that company as capital, not dividends. On December 15, 1961 the assets of the company were sold to a second company, C. Smythe for Sand Ltd., leaving cash as the only asset left in C. Smythe Ltd. (Step 1 in Fig. 2). The shares of C. Smythe Ltd. were to be purchased by F.H. Cameron Ltd. and Dabne Enterprises Ltd. (two related companies, as opposed to the single purchaser in *McNichol*). On December 28th, 1961, a bank loan was obtained by the purchasing companies from the Bank of Montreal, secured by promissory notes (Step 2 in Fig. 2). The transfer of the shares was also carried out on December 28, 1961 when the taxpayers resigned as directors and officers of C. Smythe Ltd. and handed the company seal, records and share capital over to the purchasing companies (Step 3 in Fig. 2). The assets of C. Smythe Ltd. were used by the purchasing companies to repay the loans made by the Bank of Montreal on January 2, 1962.

Judson J. (for the Court) found that subsection 81(1) [now subsection 84(2)] was sufficient to dispose of the appeal, saying:

> It is unnecessary to appeal to any other section of the *Act*. This section covers specifically the case before us.[7]

In finding that the section applied to the fact situation, he determined that the true essence of the transaction was a winding-up or discontinuance of C. Smythe Ltd. That there were no formalities associated with the dissolution of the company was of no consequence to his Lordship's finding that the normative transaction was indeed a winding-up:

> I would hold that there was a winding-up and a discontinuance of the business of the old company, although it is apparent that there was no formal liquidation under the *Winding-up Act* or the winding-up provisions of the *Ontario Companies Act*.[8]

This finding was reinforced by reference to *Merritt* v. *M.N.R.*, where Maclean P. stated:

> I entertain no difficulty over the construction to be given the words "winding-up", "discontinuance" or "reorganization," as used in s.19 [a predecessor to subsection 84(2)] of the Act. In construing these words, we must look at the substance and form of what was done here.... There was no "winding-up" of the Security Company by a liquidation, but there was in fact, I think, a winding-up of the business of that company and I think the word "winding-up" may be given that meaning here, although I need not definitely so decide because, in any event, there was a "discontinuance" of the business, and whether that was brought about by a sale...or amalgamation...is, in my opinion, immaterial. . . . What was done with the business fell somewhere within the meaning and spirit of those words.[9]

Although the transactions in *Smythe* and *McNichol* are identical in all material respects, Judge Bonner decided that there are four grounds on which *Smythe* may be distinguished. I will deal with these in turn.

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[7] *Supra* note 5.
[8] *Ibid.* at 563.
[9] [1941] Ex. C.R. 175 at 181.

First, when comparing the *Smythe* case, Judge Bonner puts forward the view that:

> The [Supreme Court of Canada in *Smythe*] described the steps taken as "artificial transactions" and stated that their purpose was to distribute or appropriate to the shareholders the undistributed income of the old company.... In my opinion *Smythe* is not analogous to the present case. I am unable to discover any basis on which the sale by the appellants of the Bec shares can be described as "artificial."[10]

Once the assets of the original companies in both transactions were liquidated, both groups of shareholders had as their purpose the distribution or appropriation of the income of these companies. In both cases the taxpayers had expert tax advice which enabled them to devise schemes by which the form of the transaction was far different from its substance. The "artificial" nature of the *McNichol* transaction seems readily apparent. The purchaser was made sole director and officer of the company he was purchasing immediately before the transaction in order to facilitate the sale. Bec had no assets other than cash, and no prospects for carrying on future business of any kind. The substance of the transaction in *McNichol* was a winding-up of Bec. Any method by which this end was achieved that could not be seen as being prima facie a winding-up is "artificial" in the same way that the transactions in *Smythe* were found to be artificial.

Judge Bonner provided a second ground on which *Smythe* was distinguishable from the facts in *McNichol*:

> By reason of the form of the transaction the appellants did not, in the end, receive any property which at any time belonged to Bec. Bec retained its property and carried it forward into the amalgamated company. I reiterate that it cannot be said that Bec's property was distributed or otherwise appropriated to the appellants "in any manner whatever."[11]

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[10] *Supra* note 1 at 2100.

[11] *Ibid.*

If the payment to the shareholders being made from borrowed money is an important factor in holding that the transaction in the *McNichol* case is not a winding-up, then it seems the Court is contradicting the reasoning of the Supreme Court of Canada in *Smythe*. In that judgment, Judson J. quoted the following passage from *Merritt* v. *M.N.R.* with approval:

> It is immaterial, in my opinion, that the consideration received by the appellant for her shares happened to reach her directly from the [purchaser] or the [wound-up company].[12]

However, during the course of his GAAR analysis later in the judgment, Judge Bonner compounds the problematic nature of his decision on this point when he finds that Bec's undistributed income was paid out to the taxpayers. In this context he writes: "Bec's surplus was, at the very least, indirectly used to fund the price paid to the appellants for their shares."[13] Clearly, the money cannot be said to have come from one place for the purpose of a subsection 84(2) analysis and from another when a GAAR test is applied.

Third, a timing element is introduced into the subsection 84(2) discussion in the *McNichol* judgment. Judge Bonner suggests that "because Bec retained its property for some time after the purchase price was paid to the appellants" the reasoning from *Merritt* as regards the distribution of property from Bec is somehow inapplicable to a subsection 84(2) analysis.[14] The time between the transfer of the shares and the repayment of the loan was twenty-three days, all of which were within the personal taxation years of the appellants. This contrasts with the five day time lag in *Smythe* which straddled the 1961–1962 taxation years. Notwithstanding that the money used to make the payment in *Smythe* was repaid in 1962, the Exchequer Court reassessed the returns of the taxpayers for the year 1961.[15] This suggests that the time at which the loan is repaid is not determinative of when the winding-up is deemed to

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[12] *Supra* note 9.
[13] *Supra* note 1 at 2110.
[14] *Ibid.* at 2099.
[15] *Smythe* v. *M.N.R.* (1967), 67 D.T.C. 5334 (Ex. Ct.) at 5339.

have occurred. Surely there is no significant difference between a twenty-three day period and a five day period. There is a certain amount of absurdity in suggesting that all a taxpayer need do to defeat subsection 84(2) is maintain the assets of the purchased company in a bank account for 23 days before disposing of them. Additionally, the fact that the assets of Bec were used as security for the loan rendered them subject to the in rem rights of the Bank as soon as the loan was advanced. The funds were in fact used to repay the loan, and were thus subject to control by the Bank for the entire twenty-three days.

The fact that Bec's assets were used as security for the loan is also material to countering the fourth and final argument put forward by the Court in *McNichol* for denying the application of subsection 84(2). The judgment suggests that:

> The respondent's characterization of the transaction as something other than a sale of shares rests in part on the premise that the appellants participated in or in some way were responsible for the events which followed the share sale.[16]

According to the Supreme Court of Canada's analysis in *Smythe*, what happens after the share sale is immaterial; this is, with respect, the better position. The *McNichol* argument can be addressed when it is recalled that the security held by the Bank in the form of the Bec assets was only available because the taxpayers effected what was, in the words of the bank manager, a "somewhat unusual" transaction. It seems unlikely that the taxpayers did not know exactly what would happen after Beformac used the loan to purchase the shares: the security would be used to pay the loan. In any event, as noted above, what a purchaser does with the actual assets of a company after buying shares is not, by the reasoning of Judson J. in *Smythe*, material to determining the time of winding-up for the purposes of deeming a dividend payment under subsection 84(2).

The subsection 84(2) argument should have been sufficient to dispose of the appeal in *McNichol*. The fact that the Court found it insufficient is unfortunate for two reasons. First, a subsection 84(2)

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[16] *Supra* note 1 at 2100.

analysis would have properly entitled Bec to a dividend tax refund by reason of section 129. This could have resulted in a greater amount of money being distributed to the taxpayers either directly as shareholders of Bec on wind-up, or indirectly as an increase in the price paid by Beformac to purchase the shares of Bec from the taxpayers. Secondly, as will be elaborated below, the application of the GAAR by the Court does not supply clear precedent for future use of the rule.[17]

III. THE GAAR ANALYSIS

The current version of the GAAR was introduced as an amendment to the *Act* on June 30, 1988.[18] In its final form, the charging provision of the section reads as follows:

> 245(2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

Subsection 245(3) defines the meaning of "avoidance transaction":

> An avoidance transaction means any transaction
>
> (a) that, 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.

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[17] Note that in the second case in which the GAAR was judicially considered, Bowman T.C.C.J. found subsection 84(2) to be applicable and sufficient to dispose of a virtually identical fact situation. See *RMM Canadian Enterprises Inc. et al.* v. *The Queen* (1997), 97 D.T.C. 302.

[18] Bill C-139, *An Act to amend the Income Tax Act, the Queen Pension Plan, the Unemployment Insurance Act, 1971, the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977 and certain related Acts*, 2nd Sess., 33rd Parl., 1988.

> (b) 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.

A "tax benefit" is defined as:

> 245(1) "tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act.

In other words, where a transaction results in a tax benefit in the form of a reduction, avoidance or deferral of tax or other amount payable under the *Act*, and is not made primarily for *bona fide* purposes other than to obtain a tax benefit, it will be considered an avoidance transaction for the purposes of the GAAR.

The requirement in subsection 245(3) that the transaction be made for *bona fide* purposes is likely a result of the rejection of the "business purpose test" by the Supreme Court of Canada in the *Stubart* case.[19] An earlier version of the GAAR proposed by the Department of Finance was formulated to exclude any transaction that was not made for *bona fide* business purposes.[20] This was rejected in favour of the rule as currently enacted, which incorporates the business purpose test, and is also broad enough to capture non-business motivated transactions such as those involved in estate planning. It should also be noted that section 245 contains an explicit reference to "a series of transactions", which codifies the common law "step transaction doctrine."[21]

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[19] In *Stubart Investments* v. *The Queen*, [1984] C.T.C. 294, the notion that a transaction must be fueled by a business, rather than tax driven, purpose was rejected. All of the taxpayer's dealings in *Stubart* were inspired solely by a desire to shelter the income of one corporation in the losses of a related corporation. The Court decided to "reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or *bona fide* business purpose" *ibid.*: at 314.

[20] V. Krishna, *Tax Avoidance: The General Anti-Avoidance Rule* (Toronto: Carswell, 1990) at 30-31.

[21] The "step transaction doctrine" has been devised by the courts to deal with situations where single steps in a series of transactions do not offend income tax

If the transaction is not characterized as an avoidance transaction the rule will not be applied. If, however, an avoidance transaction is found, subsection 245(2) provides discretion to determine the tax consequences "as is reasonable in the circumstances in order to deny a tax benefit." This is a generous grant of administrative discretion.

The GAAR also contains a relieving provision in subsection 245(4):

> 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 this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

It is not clear how this relieving provision, with its objective test, operates to provide "greater certainty" to the application of subsection 245(2). What subsection 245(4) might do, however, is delimit a legislative version of the "object and spirit" interpretation doctrine within the *Act*.[22] If the avoidance transaction cannot

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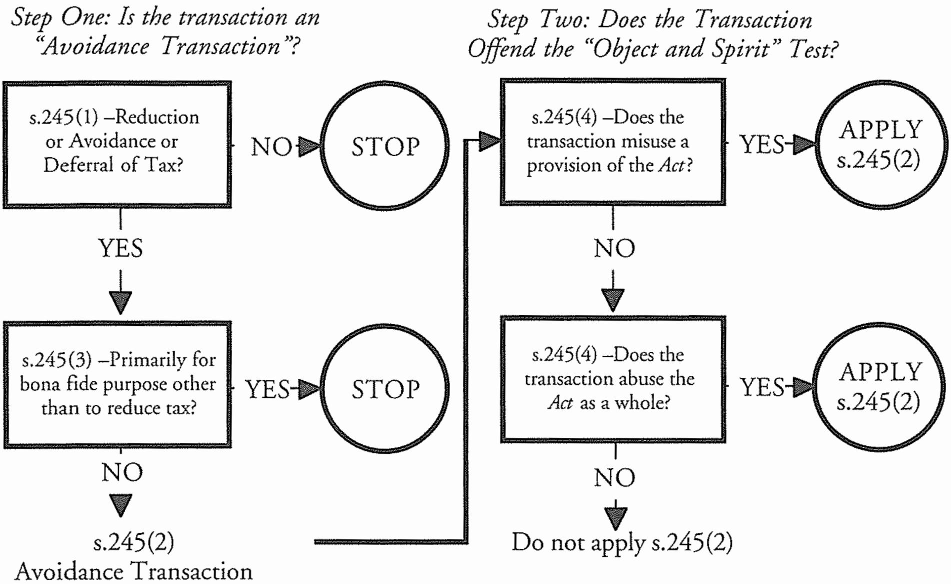
legislation individually, but effect a result that runs contrary to the legislation when the series is analyzed as a whole. Courts in the United States have developed an approach whereby the tax consequences of a series are determined as a result of the economic substance of the series. In the U.K., *Furniss (Inspector of Taxes)* v. *Dawson*, [1984] 1 All E.R. 530 (H.L.) instructs that any transaction in a series which has been inserted purely for tax reasons may be ignored when determining the nature of the combined steps—in effect applying a business purpose test to each step.

[22] Traditionally, income tax provisions were interpreted according to their literal meaning, without taking into account the underlying objects of the legislation [see e.g. *C.I.R.* v. *The Duke of Westminster*, [1936] A.C. 1 (H.L.)]. Such a method of interpretation is generally at odds with the principles used in the interpretation of other statutes, where the 'object and spirit' of the legislation can be construed as an aid to applying the provision at issue. In *Stubart Investments* v. *The Queen* [*supra* note 19] the doctrine of strict interpretation was rejected in favour of an approach which considered the 'object and spirit' of provisions of the *Income Tax Act* as well as their literal meaning. This development was later tempered by the majority judgment in *Antosko* v. *The Queen*, [1994] 2 C.T.C. 25 (S.C.C.) where Iaccobucci J. decided that the 'object and spirit' approach should be reserved for provisions which are ambiguous, and that the literal approach to interpretation should continue to be applied where "the words of the statute are clear and plain."

"reasonably be considered" to misuse either a particular section of the *Act*, or "abuse" the *Act* as a whole, then it will not fall within the parameters of subsection 245(2).

Figure 3 is a diagram of the rule's application.

Fig. 3



As noted above, the Minister used the GAAR as the sole basis for disallowing the transaction in *McNichol*, and only subsequently added subsection 84(2) and section 84.1 as alternative grounds for rejection. The following is an analysis of the Court's application of the GAAR in *McNichol*.

1. Step One: Is the Transaction an "Avoidance Transaction"?

The first step in ascertaining whether there is an "avoidance transaction" for the purposes of subsection 245(2) is to determine whether a "tax benefit" has accrued to the taxpayer within the meaning of subsection 245(1). As discussed above, the definition of "tax benefit" includes a reduction, avoidance or deferral of any amount payable under the *Act* or an increase in a refund of tax or other amount.

In *McNichol*, the tax benefit was found to be the "difference between tax payable by the appellants upon receipt of the taxable dividends and that payable upon realization of capital gains from the disposition of shares."[23] This result was arrived at by comparing the transaction in which the shares were transferred to the likely method of effecting the same result. Judge Bonner declares that a reduction or avoidance of tax "require[s] the identification in any given set of circumstances of a norm or standard against which reduction is to be measured."[24] His Honour found that:

> Their choice was between distribution of that accumulated surplus by way of liquidating dividend and sale of the shares and in choosing the latter they chose a transaction which resulted in a tax benefit within the s.245(1) definition.[25]

The Court's suggestion that a "norm or standard" be determined for the purposes of measuring a tax benefit appears to be on the right track. It should be noted, however, that in suggesting that the share transfer be compared to a liquidating dividend the Court comes dangerously close to contradicting its earlier subsection 84(2) analysis wherein it found that Bec was not wound-up.

The second step in analyzing whether a transaction is an "avoidance transaction" under subsection 245(3) is to determine whether it was undertaken or arranged for a *bona fide* purpose other than to reduce tax. The appellants argued that the primary purpose of the transaction was to "terminate their association with each other in the common ownership of Bec."[26] In deciding that the appellants did not meet their burden of proof on this issue, Judge Bonner found that, because all that was left to do was liquidate the assets of Bec, the true purpose of the transaction was to allow the taxpayers to take advantage of the capital gains exemption then present in subsection 110.6(3) of the *Act*.

Such an approach to determining whether a transaction is an avoidance transaction for the purposes of subsection 245(3) is likely over-broad. It expands the scope of subsection 245(3) to include tax avoidance measures which are specifically authorized by the *Act*

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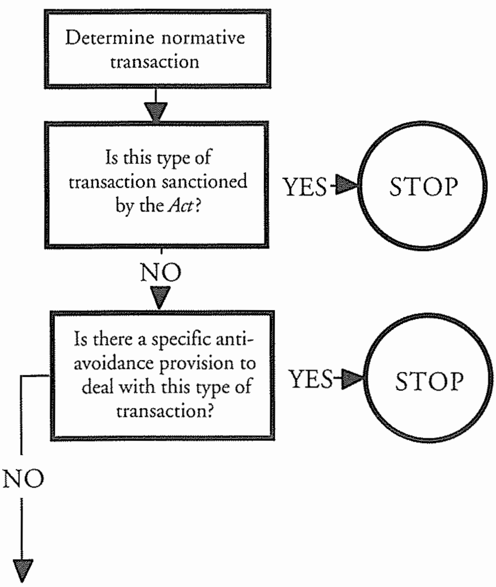
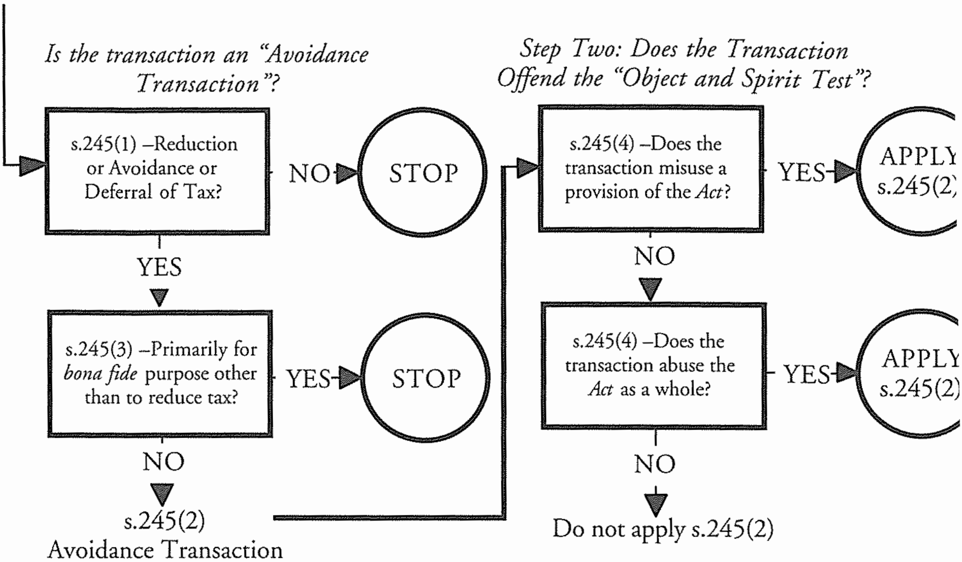
[23] *Supra* note 1 at 2108.
[24] *Ibid.*
[25] *Ibid.*
[26] *Ibid.*

as tax expenditure provisions. Section 146, for example, allows for the accumulation of tax deferred income in a registered retirement savings plan ("RRSP"). This is clearly a tax benefit within the meaning of subsection 245(1) as it results in the deferral of tax. Likewise, it may be executed in the prescribed manner without conforming to any requirement that the money be used for retirement and, if so, would not have a *bona fide* primary purpose. In applying the test set out by the Court in *McNichol*, a contribution to an RRSP, and any other government sponsored avoidance measures would be "avoidance transactions" within the meaning of subsection 245(3).

As suggested above, the substance of the *McNichol* transaction was the winding-up of Bec. It is suggested that where there is a specific provision in the *Act* which will accommodate the impugned transaction, that section should be applied instead of the GAAR. Likewise, if the activity in issue is sanctioned by the *Act*, it should not be classified as an avoidance transaction and the GAAR should not be applied. If, and only if, the transaction is of such a character that it is not caught by these preliminary steps, then the subsection 245(3) test should be invoked. Figure 4 represents the addition of these steps to the flowchart from Figure 3.

Fig. 4.





The application of the GAAR as a residual provision is consonant with its intended use. The Explanatory Notes to Bill C-139, which contained the new section 245, described the rule as "an important supplement to the tools that may be used to counter abusive tax avoidance transactions."[27] Furthermore, it states that "[t]he new rule applies as a provision of last resort after the application of the other provisions of the *Act*, including specific anti-avoidance measures."[28]

There is judicial recognition of this view in the decision of Judge Bowman in the *RMM Canada Enterprises* case:

> If I am right in believing that sections 84 and 212 or, alternatively, section 212.1, by themselves result in taxing this surplus strip, recourse to section 245 is not only unnecessary but inappropriate. The application of section 245 depends upon the existence of an "avoidance

[27] Explanatory Notes to Bill C-139, *An Act to amend the Income Tax Act, the Queen Pension Plan, the Unemployment Insurance Act, 1971, the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977 and certain related Acts*, 2nd Sess., 33rd Parl., 1988.
[28] *Ibid.*

> transaction" which is a transaction that, but for this section, would result in a tax benefit. In other words, for section 245 to apply, the transaction has to otherwise "work" in the sense of achieving its intended fiscal result. Therefore section 245 is aimed at successful tax avoidance schemes. If they do not work in any event section 245 is unnecessary. As stated above in my discussion of section 84, I do not think the transaction works, quite apart from section 245. If I am wrong in that conclusion, I must consider section 245.[29]

If this approach was applied to the facts in *McNichol*, the transaction would be put squarely within the domain of subsection 84(2) as a result of its classification, in substance, as a winding-up. As discussed above, this would be consistent with the reasoning of the Supreme Court of Canada in *Smythe* and its affirmation of *Merritt*. Judge Bonner's "standard or norm" upon which he bases his finding that there is a tax benefit as defined in subsection 245(1), is that of a "liquidating dividend." Here the normative transaction—a winding-up— and the professed "standard or norm"—a liquidating dividend—are one and the same. This *per se* should have led squarely to an application of subsection 84(2).

2. Step Two: Does the Transaction Result in a Misuse or Abuse?

As discussed above, subsection 245(4) is a relieving provision. If a transaction does not result in a misuse of the provision at issue, or an abuse of the *Act* read as a whole, subsection 245(4) deems subsection 245(2) not to apply. Judge Bonner found the transaction in *McNichol* to be a misuse of the capital gain provisions found in sections 38 and 110.6 of the *Act* and an abuse of the "provisions of the *Act*, read as a whole, which contemplate that distributions of corporate property to shareholders are to be treated as income in the hands of the shareholders."[30] Among these provisions Judge Bonner mentions section 15 and, surprisingly, section 84. As regards the latter, his Honour points out that:

> [T]he appellants have sought to realize the economic value of Bec's accumulated surplus by means of a

[29] *Supra* note 7 at 311.
[30] *Supra* note 1 at 2112.

> transaction characterized as a sale of shares giving rise to a capital gain in preference to a distribution of a liquidating dividend taxable under s. 84. The scheme of the Act calls for the treatment of distributions to shareholders of corporate property as income. The form of such distributions is generally speaking irrelevant.[31]

It seems paradoxical that a transaction which is described for the purposes of the GAAR test to be "a classic example of surplus stripping"[32] was not also found to be a deemed dividend under subsection 84(2). Clearly, the "form of such distributions" is "irrelevant" in either case. It appears that it is only Judge Bonner's tendentious approach to the GAAR that allowed it to create this artificial distinction, supplanting long-established anti-avoidance principles.

3. The Remedy

Because the Minister found that the transaction at issue in *McNichol* was within the sole purview of the GAAR, the tax consequences to the taxpayers were denied as was felt to be "reasonable in the circumstances" per subsection 245(2). Subsection 245(5) was used in recharacterizing the tax consequences of the transaction. That provision reads as follows:

> Without restricting the generality of subsection (2),
>
> (a) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,
>
> (b) any such deduction, any income, loss or other amount or part thereof maybe allocated to any person,
>
> (c) the nature of any payment or other amount may be recharacterized, and
>
> (d) the tax effects that would otherwise result from the application of other provisions of this Act may be

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[31] *Supra* note 1 at 2110.
[32] *Ibid.*

> ignored, in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would but for this section, result, directly or indirectly, from an avoidance transaction.

Paragraph 245(5)(c) was employed by the Minister to recharacterize the nature of the payment to the taxpayers. The assessor did not choose to put the taxpayers fully in the position they would have been if they had liquidated their shares; this would have resulted in a dividend tax refund for Bec under section 129. The taxpayers argued that this payment would have accrued to them indirectly as shareholders of the company, and should have been allowed. The Court, relying on paragraph 245(5)(d), confirmed the original assessment on the grounds that section 129 had been given consideration by the assessor, and was rejected pursuant to administrative discretion.

The appellants' section 129 argument is viable under the proposed approach outlined in Figure 4, as this transaction would have been diverted to the ambit of section 84(2) before reaching the GAAR stage. In the *Smythe* case, a dividend credit was available directly to the appellants *qua* shareholders, and was found by Judson J. to be applicable as a result of the reassessment:

> There appears to be no doubt that the re-assessments were made under s.81(1) of the Act on the basis that there had been a winding-up, discontinuance or reorganization of the old company.... These assessments should be made under this section with the necessary consequences of a tax credit under s.38(1).[33]

Although the credit available to the taxpayers in *Smythe* would have accrued directly to the taxpayers under assessment (rather than indirectly as a result of a refund to the corporation as in *McNichol*), the Court recognizes the applicability of relieving provisions to transactions reassessed under anti-avoidance legislation.

The administrative discretion conferred upon Revenue Canada to reassess transactions under the GAAR has been the source of much

[33] *Supra* note 5 at 563.

controversy.[34] Revenue Canada has attempted to allay fears regarding its power in this regard by funnelling all GAAR reassessments through its Taxation Head Office.[35] Although this may provide for a certain amount of consistency in the rule's application, it has been said that the rule creates inherent uncertainty. Krishna has described the power of the informal committee set up to review the application of the GAAR as possessing a unique brawn:

> [T]his "informal committee" of Revenue Canada exerts enormous administrative power. Although, in theory, the power of this committee is neither greater nor less than the power of the Rulings Division to "bless or kill" proposed transactions, the committee exerts a far greater influence in respect of GAAR. A Committee decision to turn down a request for a GAAR ruling will have a chilling effect on proposed transactions. The administrative perception of what is "abusive" or "offensive" will determine the disposition of most, if not all, proposed transactions. The costs and delays involved in potential litigation will be sufficient to thwart the administrator's decision in most cases.[36]

Howard Kellough describes this "chilling effect" as the "fear factor," claiming that it is enhanced by public pronouncements such as the following speech given by then Minister David Anderson:

> You're going to see a lot of professional people who've been cheating in jail. That's what we're after. We're going to audit and we're going to enforce, and I'm telling our people I want prosecutions to the hilt.... I'm really upset about the number of professions, in particular, chartered accountants, lawyers, people who should know, who have a professional responsibility to

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[34] See submissions by The Joint Commission on taxation of the C.B.A. and C.I.C.A., reprinted as Appendix A.2 and A.8 in V. Krishna, *Tax Avoidance: The General Anti-Avoidance Rule, supra* note 20.

[35] *Information Circular* IC-88-2 , "General Anti-Avoidance Rule: Section 245 of the Income Tax Act" (21 October 1988).

[36] *Supra* note 20 at 75–76.

> advise on tax matters effectively and they're turning their skills to the evasion of taxes.[37]

Information Circular IC 88-2 and the supplement thereto describe various situations where, in the opinion of Revenue Canada, the GAAR will and will not apply to given transactions.[38] These circulars are of limited value in predicting the situations in which GAAR will be applied, since they are relevant only to the specific fact situations contained in the circular. A further limitation is that the circulars indicate only that the GAAR does or does not apply to the transaction, without giving sufficient commentary on how the rule is applied to the transactions.

In conducting the reassessment under the GAAR in *McNichol*, it is unclear whether the Minister compared the transaction undertaken by the taxpayer to what should have been done or could have been done in effecting the distribution of the surplus of Bec. This is a question of immense importance to the recharacterization of transactions for the purposes of denying a tax benefit. The recent Australian High Court decision in *Spotless*[39] is an example of such a recharacterization under the Australian general anti-avoidance provision found in Part IVA of the *Income Tax Assessment Act*, 1936 (Cth). The taxpayers in *Spotless* required a short-term investment in which to deposit A$40 million. Both domestic and off-shore possibilities were reviewed, with an off-shore investment in the Cook Islands ending up as the vehicle of choice. The interest rate for this investment was 4.5% lower than that which could have been obtained in Australia, but the combination of a low tax rate in the Cook Islands and the tax exempt status of the income in Australia made the investment the most attractive alternative. The Full Court found that the transaction was a *bona fide* attempt to obtain the greatest amount of

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[37] H. Kellough, "Tax Avoidance: 1945–1995" (1995) 43:5 Can. Tax J. 1819 at 1833–1834.

[38] *Information Circular* IC 88-2, *supra* note 35; *Information Circular* IC 88-22 Supp. 1 "General Anti-Avoidance Rule" (13 July 1990).

[39] *Commissioner of Taxation of the Commonwealth of Australia* v. *Spotless Services Ltd.* (1995), 95 A.T.C. 4775 (Full F.C.); *Commissioner of Taxation of the Commonwealth of Australia* v. *Spotless Finance Pty Ltd.* (1996), 96 A.T.C. 5201 (Full H.C.).

return on the taxpayers' investment.[40] The High Court overturned this ruling of the Full Court, finding that the scheme gave rise to an improper tax benefit under Part IVA.

For the purposes of this note, it is the method of comparison used by the High Court to determine the benefit to the taxpayers that is of importance. The taxpayers submitted that,

> there is no possible way of knowing whether the amount actually derived from the investment, or any other particular amount, would have been included in the assessable income of the taxpayers had they chosen not to make the investment that they did. It is said that if the taxpayers did not enter into the scheme, there would have been no interest and no amount would have been included in assessable income with the result that the definition of "tax benefit" makes no sense in the context of the present case.[41]

The Court rejected this argument, finding it sufficient that the "amount in question might reasonably have been included in the assessable income if the scheme had not been entered into or carried out."[42] It determined the amount of the benefit to be the amount equal to the interest earned on the investment less the withholding tax paid in the Cook Islands. This figure is based on the fact that the interest rate in Australia was not less than that obtained in the Cook Islands, and that, when reasonably considered, Australia was the likely place that the money would otherwise be invested. The facts of the case reveal, however, that there were other off-shore schemes rejected by the taxpayers in favour of the Cook Islands transaction. One such scheme was put forward by Rothschild Australia Ltd. to invest the money in Hong Kong. Presuming that the appropriate tax clearing certificate could be obtained for the investment, there is no reason to expect that it would not have been the next best choice for the taxpayers. It is suggested that making the default position a domestic investment is unduly harsh, and will have a "chilling-effect" on taxpayers considering legitimate off-shore transactions.

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[40] Full F.C., *ibid.*
[41] Full H.C., *ibid.* at para 41.
[42] *Ibid.* at para 45.

The decision in *Peabody*, another recent Australian case, made a somewhat more helpful statement regarding what would be an appropriate base on which to determine the valuation of a "tax benefit."[43] When considering the statement by the Commissioner that the taxpayer might have been "reasonably expected" to follow an alternate course of action the Court noted that:

> A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.[44]

Under subsection 245(2) of the Canadian rule, any tax benefit can be denied as is "reasonable in the circumstances." The word "reasonable" suggests an objective test, while "in the circumstances" is likely to involve at least a modicum of consideration of the subjective intent of the taxpayer. It is admitted that this subjective evaluation will be difficult to accomplish in light of the guarded stance likely to be taken by the taxpayer, but the consideration should nonetheless be an important one. With regard to the *McNichol* case, it is arguable that, in circumstances involving another purchaser, the building may not have been sold prior to the distribution of the shares. If Bec was not sold as a cash company, but rather with the building as its only asset, it is unlikely that GAAR would have been applied by the assessor. However, the "benefit" to the taxpayers would have remained—a capital gain, rather than a liquidating dividend, would still have accrued to the taxpayers.

The Court in *McNichol* stated that "[d]ifficulties may exist in other cases in identifying the standard [against which a reduction in tax is to be measured] but in this case there is no such difficulty."[45] Perhaps the Federal Court of Appeal will alleviate this dearth of judicial guidance so that a final determination on the "tax benefit" issue can be made.[46]

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[43] *F.C. of T.* v. *Peabody* (1994), 94 A.T.C. 4663 (Full H.C.).
[44] *Ibid.* at para 31.
[45] *Supra* note 1 at 2108.
[46] An appeal to the Federal Court of Appeal has been filed.

IV. CONCLUSION

If the GAAR is to be effective in curbing tax avoidance, while providing enough certainty for taxpayers to order their affairs, it is necessary that a clear structure for its operation be devised. *McNichol* v. *The Queen*, as the first judicial decision on the application of the GAAR provided an opportunity to clearly define the scope of the rule and set out how it should be used in practice. Unfortunately, this opportunity was not put to use. Instead, the decision in *McNichol* merely supports Revenue Canada's position that the GAAR "applies to a transaction in which a shareholder receives a capital gain instead of a dividend on the disposition of property...."[47] By abandoning the application of a specific anti-avoidance provision in favour of applying the GAAR, the ruling further obfuscates the route that should be taken in administering the rule.

This note suggests that the better approach, consistent with case law and with the intention of the drafters of the legislation, is that the presence of effective, specific anti-avoidance rules should preclude the application of the GAAR. Such an approach would provide increased balance between the need of Revenue Canada to ensure the fair and neutral application of the *Act*, and those of the taxpayer to structure transactions with certainty.

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[47] A. Santos, "GAAR Hits Surplus Stripping"(1997) 5:2 *Canadian Tax Highlights* at 9.