Tax memo

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Reflections on Supreme Court ruling on GAAR—Copthorne Holdings Ltd.

Our comprehensive commentary on the SCC decision that GAAR applied in ***Copthorne Holdings Ltd. v. The Queen****.*

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On December 16, 2011, the Supreme Court of Canada (SCC) released its long-awaited GAAR decision in **Copthorne Holdings Ltd. v. The Queen**, 2011 SCC 63, which was argued in January 2011. This *Tax memo* provides a comprehensive commentary on the SCC's decision. For an overview of the case, see our *Tax memo* "New Supreme Court of Canada ruling on GAAR—Copthorne Holdings Ltd." at **www.pwc.com/ca/taxmemo**.

In a unanimous decision, the SCC held that the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax Act* (the Act) applied to a series of transactions entered into by the corporate group of which the taxpayer was a part. These transactions had the effect of duplicating cross-border paid-up capital (PUC). PUC can be a valuable tax attribute because Canadian tax rules allow a corporation to return PUC to a non-resident shareholder without withholding tax.

Background

Copthorne is only the fourth case in which the SCC has considered the application of the GAAR even though the rule has been in the Act for over 20 years. The SCC first ruled on the GAAR in 2005 in two decisions, **Canada Trustco**[1] and **Kaulius**,[2] in which it set out certain guidelines on the interpretation and application of the GAAR. Each was unanimous, in one case finding in the taxpayer's favour (**Canada Trustco**) and in the other (**Kaulius**), against the taxpayer.

The SCC's third GAAR decision in **Lipson**[3] in early 2009 was a split decision with three separate sets of reasons and a strong dissent. It seems likely that one of the reasons for the lengthy delay in rendering the decision in **Copthorne** was a desire to avoid, if possible, another split decision and to attempt to provide some clarification on some key elements of the GAAR.

1. **Canada Trustco Mortgage Co. v. Canada**, 2005 SCC 54.
2. **Kaulius v. Canada**, 2005 SCC 55.
3. **Jordan B. Lipson, Earl Lipson v. The Queen**, 2009 SCC 1, is discussed in our *Tax memos* "Important Supreme Court Ruling on GAAR—Highlights" and "New Supreme Court Ruling on GAAR—Reflections on the Lipson Case" at **www.pwc.com/ca/taxmemo**.

The GAAR

Three key requirements must be satisfied for the GAAR to be successfully invoked:

1) A "tax benefit" must be identified.
2) That tax benefit must be the result of an "avoidance transaction" or a series of transactions of which an avoidance transaction is a part. An avoidance transaction is in general terms a transaction that has, as its primary purpose, the obtaining of a tax benefit.[4]
3) It must also be shown that for the taxpayer to obtain the tax benefit would be an abuse or misuse of the provisions of the Act.

While the taxpayer has the onus of proving that the threshold requirements in 1) and 2) are not met, the Minister has the onus of proving that the third condition is met.

Key issues

There were two key issues in **Copthorne**:

- The interpretation of "series of transactions." Although the concept of a series of transactions is a "common law" concept that has been developed in the case law, the Act contains, in subsection 248(10), an extended definition of "series of transactions," which incorporates in a series of transactions (as determined under the common law tests) other transactions that are undertaken "in contemplation of" that series. As will be explained in more detail later in this *Tax memo*, in **Copthorne**, the taxpayer argued that the transaction that resulted in the tax benefit (avoidance of withholding tax), a share redemption, was not part of the series of earlier transactions (a corporate reorganization) in which the opportunity to realize the benefit was created.
- Whether, assuming that the share redemption was part of the earlier series, the tax planning constituted a misuse or abuse of the Act. In simple terms, the case involved the duplication of cross-border PUC and the use of that PUC to make a tax-free distribution to a non-resident shareholder. The duplication was attributable to a decision made to effect a particular corporate reorganization (an amalgamation) as a "horizontal" rather than a "vertical" amalgamation. There was no doubt that absent the GAAR, the non-resident shareholder was entitled to rely on the PUC.

Facts

Copthorne I, a predecessor of the taxpayer, was incorporated under Canadian law to acquire a hotel in Toronto. It had nominal PUC and its shares were owned by a Netherlands company (Big City) controlled by Mr. Li Ka-Shing. Copthorne I realized a significant capital gain on the sale of the hotel in 1989. The proceeds of the 1989 hotel sale were invested by Copthorne I in Copthorne Overseas Investment Ltd. (COIL), a wholly owned Barbados corporation that carried on an active bond-trading business.

VHHC I was a Canadian corporation incorporated by Li Ka-Shing's son Victor. Victor and related entities capitalized VHHC I with $97 million and VHHC I used $67 million of this capital to invest in the share capital of VHHC II, another Canadian corporation. VHHC II used the $67 million to invest in shares of Husky Oil Limited (Husky), which by the end of 1991 had significantly declined in value.

First series of transactions

The first relevant series of transactions (the First Series) took place from 1992 to January 1, 1994. In 1992, transactions were undertaken to consolidate the realized gain in Copthorne I and the accrued loss in VHHC II on the Husky shares. The first step was the sale by VHHC I of its shares of VHHC II (having PUC of $67 million) to Copthorne I for their estimated fair market value of $1,000.

The second step was to amalgamate Copthorne I and VHHC II to allow for consolidation of group profit and loss, and simplify the corporate structure. Because VHHC II was a wholly owned subsidiary of Copthorne I, a vertical amalgamation would eliminate the PUC attributable to the VHHC II

4. More specifically, an avoidance transaction is any transaction that results in a tax benefit or is part of a series of transactions that results in a tax benefit, unless that transaction may reasonably be considered to have been undertaken primarily for *bona fide* purposes other than to obtain the tax benefit.

shares. Instead, Copthorne I sold its shares of VHHC II to Big City, its non-resident parent, for $1,000 (the Share Sale). Copthorne I, VHHC II and two other Canadian corporations were then amalgamated to form Copthorne II on January 1, 1994 (the First Amalgamation). As a result, Big City's PUC in Copthorne II was $67 million.

Second series of transactions

The second series of transactions was undertaken in 1994 and 1995, and was triggered by Canada's announcement of tax changes that made COIL's income subject to the foreign accrual property income (FAPI) rules. Thus, it was important to move COIL out of the Canadian group if feasible. All of the shares of VHHC I and Copthorne II were transferred to L.F. Investments, a Barbados corporation, resulting in L.F. Investments owning shares of VHHC I (with PUC of $97 million) and shares of Copthorne II (with PUC of $67 million).

On January 1, 1995, Copthorne II, VHHC I and two other Canadian corporations were amalgamated to form Copthorne III with an aggregate PUC of $164 million allocated to the Class D shares held by L.F. Investments. Copthorne III then redeemed most of the Class D shares (the Redemption). Because the Redemption proceeds did not exceed the PUC of the Class D shares, absent GAAR, there was no deemed dividend subject to Canadian withholding tax.

Legislation

The following provisions of the Act were considered:

- the definition of PUC in subsection 89(1), which, in a nutshell, provides that the PUC of a class of shares is the corporate stated capital of that class, adjusted to take into account certain "grinds" contained in specific provisions of the Act listed therein, including subsection 87(3);
- the deemed dividend rule in subsection 84(3), which provides, *inter alia*, that a deemed dividend arises on the redemption of a share to the extent that the redemption amount exceeds the PUC of the redeemed shares; and
- the rule in paragraph 87(3)(a) governing PUC on amalgamations, which specifically excludes from the computation of the PUC of the amalgamated corporation, the PUC of a share held by any other predecessor corporation.

The issues

The specific issues before the SCC were:

- whether the Redemption was part of the series of transactions that included the First Series (i.e., the prior Share Sale and First Amalgamation), by virtue of the extended definition of "series of transactions" in subsection 248(10); and
- if so, whether the transactions constituted a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act, other than section 245, read as a whole within the meaning of subsection 245(4).

Basis for the reassessment

The Minister of National Revenue (Minister) applied the GAAR to the Redemption and reassessed the taxpayer for withholding tax on a $58 million deemed dividend. The Minister argued that the tax benefit was the avoidance of the withholding tax on the deemed dividend and that the avoidance transaction was the Share Sale, which allowed a horizontal amalgamation of Copthorne I and VHHC II, and preserved VHHC II's $67 million of PUC. The Minister further argued that the result was a misuse or an abuse of the provisions of the Act—more specifically, subsection 84(3), paragraph 87(3)(a) and the definition of PUC in subsection 89(1).

Lower court decisions

The Minister was successful in both the Tax Court of Canada (2007 DTC 1230) (TCC) and the Federal Court of Appeal (2009 DTC 5101) (FCA). The TCC found that the taxpayer had received a tax benefit (the avoidance of withholding tax) and that this benefit resulted from an avoidance transaction (the Share Sale). The TCC ruled that the transactions in the First Series and the Redemption were part of the same "series of transactions," pursuant to the extended definition of that term found in subsection 248(10).

As to whether the series of transactions constituted abusive tax avoidance, the TCC applied a "unified textual, contextual and purposive analysis" to the

definition of PUC in subsection 89(1), the deemed dividend rule in subsection 84(3) and the rule governing PUC on amalgamations in paragraph 87(3)(a), and found that these provisions had been misused and abused. The TCC reasoned that although there was no general policy against dividend stripping in the Act, an artificial doubling-up of PUC was contrary to the object and spirit of the provisions and frustrated that object and spirit.

The FCA upheld this decision, finding that the TCC had not made a palpable and overriding error in its determination that the Share Sale and the Redemption were part of the same series of transactions pursuant to subsection 248(10). The FCA also affirmed that the trial judge had not erred when it ruled that the Share Sale was an avoidance transaction and that the taxpayer had enjoyed a tax benefit. The FCA agreed with the TCC's conclusion that there was abusive tax avoidance.

Supreme Court of Canada decision

Extended definition of "series of transactions"

In the SCC, the taxpayer focused on the extended definition of "series of transactions" and, in particular, on the requirement that in order for a transaction that was not otherwise part of a series of transactions (on the common law test) to be included in a series of transactions, it must be completed "in contemplation of" the other transaction or series of transactions. Although in its original guidelines set out in **Canada Trustco** and **Kaulius** the SCC had held that "in contemplation of" could be applied both prospectively and retrospectively, the taxpayer's counsel challenged the SCC to revisit this interpretation.

The taxpayer argued that a related transaction should be part of a series only when the series is "being contemplated by the parties" at the time the prior related transaction takes place—in other words, that the expression "in contemplation of" suggests consideration of a future event and that the words should only be applied prospectively. If this interpretation was correct, then the fact that a decision was made to first move the shares of VHHC II out from under Copthorne I before the companies amalgamated, to preserve the PUC of VHHC II, was unconnected to the later share redemption, because there was no specific plan to use the PUC in a share redemption.

The SCC declined to revisit its earlier statements in **Canada Trustco** that "in contemplation of" in the context of the extended definition of "series of transactions" could be read both prospectively and retrospectively. If a transaction (such as the Redemption transaction) is completed "because of" an earlier series of transactions (such as the transaction in which the shares of VHHC II were transferred out of Copthorne I, and Copthorne I and VHHC II were horizontally amalgamated), in the sense that the earlier PUC preserving transaction was taken into account as a relevant consideration when the decision was made to undertake the later transaction, this is a sufficient connection to make the earlier and later transactions part of the same series.

Although the SCC acknowledged that the more common use of the expression "in contemplation of" is prospective, such a reading would unduly narrow its scope. The SCC concluded that the Redemption was done in contemplation of—and was therefore part of—the First Series.

Somewhat disappointingly, the SCC did not provide much further elaboration on the nexus required between two transactions or series of transactions; it simply stated that it must be more than a mere possibility and more than a connection with an "extreme degree of remoteness," but each situation must be assessed on its facts. In some cases, the length of time between the series and the completion of the related transaction may be relevant, as would intervening events that take place.

Abusive tax avoidance

With regard to the misuse question, the taxpayer argued that PUC was simply an attribute of a share, and not an attribute of the share in relation to a particular taxpayer. The rules were clear and the results of the transactions simply followed from the specific provisions of the Act.

The taxpayer also advanced the argument that the transaction in which the shares were redeemed was not *per se* a non-taxable transaction. Although the shares had high PUC, they had a much lower adjusted cost base (ACB) and there was a capital gain on the redemption. However, in its treaty with Barbados, Canada had agreed that capital gains on shares of a company like Copthorne II were not subject to Canadian tax. The SCC noted that the argument that it accorded with the scheme of the Act that the PUC could be preserved because it would fall within the capital gains scheme of the Act had not been addressed by either lower court. The SCC further stated that this argument had not been substantiated "sufficiently" by the appellant and therefore could not be accepted.

With regard to the misuse or abuse question, the SCC confirmed what it had earlier said in **Canada Trustco**, that is, that the GAAR can be applied to deny a tax benefit only when the abusive nature of the transaction is clear. The SCC agreed that on the two amalgamations, no provision of the Act expressly required the elimination of the PUC attributable to the shares of VHHC II. However, it found that to allow the same cross-border PUC (the $67 million "tax-paid" investment by Victor Li and related companies into VHHC I and from VHHC I into VHHC II) to be used twice, frustrated the purpose of the specific rules in subsection 87(3) that would have cancelled the PUC of VHHC II if there had been a vertical amalgamation of VHHC II and Copthorne I.

The SCC also endorsed its earlier statements in **Canada Trustco** that the Minister must clearly demonstrate that the transaction is an abuse of the Act and the benefit of the doubt is given to the taxpayer. Further, a GAAR analysis must be grounded in a determination of the object, spirit or purpose of the provisions that are relied on for the tax benefit and the Minister must show that the transaction:

1) achieves an outcome the statutory provision was intended to prevent;
2) defeats the underlying rationale of the provision; or
3) circumvents a provision in a manner that frustrates or defeats its object, spirit or purpose.

The SCC drew a distinction between the proper approach to interpreting the rules in the Act (other than the GAAR) and interpreting the GAAR. Although it is now well established that the proper approach to statutory interpretation is a "unified textual, contextual and purposive approach," the SCC said that in a traditional statutory interpretation approach, the court applies the textual, contextual and purposive analysis to determine what the words of the statute mean.

However, in the GAAR context, the textual, contextual and purposive analysis is employed to determine the object, spirit or purpose of the provision. The words of the statute may be clear enough, but it is necessary to search for a rationale that underlies the words that may not be captured by the bare meaning of the words themselves. Still, determining the rationale of the relevant provisions should not be conflated with a value judgment of what is right or wrong or with theories about what tax law ought to be or ought to do.

The SCC did not engage in an examination of whether there was a general policy against surplus stripping in the Act. Instead, the SCC focused on the specific rules dealing with the PUC of an amalgamated company (subsection 87(3)) and the policy behind this provision, which states that the total PUC of the shares of an amalgamated corporation shall be limited to the PUC of the shares of the predecessor corporation, other than shares of a predecessor corporation that are held by another predecessor corporation.

The SCC found that the policy underlying the requirement to cancel the PUC of shares of one of the amalgamating companies held by another amalgamated company, which would require the PUC of a subsidiary to be cancelled in a vertical amalgamation of the subsidiary with its parent, was to recognize that in such a situation there was only one investment made with "tax-paid" funds. The SCC found that "the avoidance of a vertical amalgamation" and the preservation of the PUC of VHHC II by moving the shares out from under Copthorne I before the companies were amalgamated improperly circumvented the application of subsection 87(3).

Other implications?

The SCC certainly made no overt value judgment about the planning. It was expressly acknowledged that the planning worked, as a technical matter.

The taxpayer in **Copthorne** argued that to uphold the lower court decisions would leave the law in an untenable state of uncertainty because taxpayers acquiring a company would have no way to determine whether the PUC of shares they acquired was or was not valid PUC and could be relied on. The SCC expressly stated that its decision did not mean that in every case the PUC of an acquired share is suspect and cannot be relied on. The Court stated that a sale of shares to a third party or to an unrelated non-resident party primarily for a *bona fide* non-tax purpose would not trigger the GAAR. However, these remarks would suggest that a taxpayer might be better off if it could be established that the share acquisition was not, in the first instance, an avoidance transaction.

We take from this decision that with regard to other planning in which specific provisions limiting the creation of PUC (such as sections 84.1 and 212.1, which, respectively, are rules that prevent the "step-up" of PUC in the domestic and cross-border context in the case of certain non-arm's length transactions) caution must be exercised. This is particularly important when evaluating planning to structure around those provisions or that involves steps that might be considered to inflate PUC when there is no real increase in the "tax paid" investment that has been made. The policy behind any specific provisions that might be considered circumvented would have to be carefully examined in the context of the specific transactions that are being undertaken.

The fact that PUC is an attribute of a share and is disassociated from other attributes, like ACB, is perhaps the underlying problematic issue from a policy point of view. However, this remains a feature of the Canadian tax system. It would seem that in some cases, the concept of "tax-paid" investment may be considered relevant to a GAAR analysis. It is unfortunate that the case does not provide more clarity on what this term might encompass, because this will no doubt be an issue that will be germane in cases that will come before the TCC in the future.

How PwC can help

Because **Copthorne** was decided by the SCC, it will have important implications for taxpayers. Your PwC adviser, working with members of our affiliated law firm Wilson & Partners LLP, as well as our Tax Controversy and Dispute Resolution group, which includes former senior Department of Finance and Canada Revenue Agency (CRA) officials, can help you evaluate what this GAAR decision means for your current and future tax plans.

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