Tax memo

Canadian tax updates

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New Supreme Court of Canada ruling on GAAR—Copthorne Holdings Ltd.

Provides an overview of the SCC ruling that GAAR applied in ***Copthorne Holdings Ltd. v. The Queen****.*

December 16, 2011

The Supreme Court of Canada (SCC) today (December 16, 2011) released its decision in **Copthorne Holdings Ltd. v. The Queen**.[1] The SCC in a unanimous decision held that the general anti-avoidance rule (the GAAR) in section 245 of the *Income Tax Act* (the Act) applied to the planning engaged in by the corporate group of which Copthorne Holdings was a part.

This *Tax memo* provides an overview of the SCC's decision. PwC will issue a more comprehensive *Tax memo* shortly.

Although the GAAR was introduced almost 25 years ago, **Copthorne** is only the fourth case in which the SCC has considered its application. The most recent SCC GAAR decision prior to the **Copthorne** decision (**Lipson**,[2] in early 2009) was very divided. Consequently, today's decision (which was handed down 11 months after the hearing) has been eagerly awaited. Today's decision, in which the SCC ruled against the taxpayer, was unanimous.

Background

The case involved certain corporate reorganizations that were found to have resulted in the duplication of 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. The Minister of National Revenue (Minister) alleged that the planning was abusive. Both the Tax Court of Canada (2007 DTC 1230) and the Federal Court of Appeal (2009 DTC 5101) agreed that the GAAR applied. The SCC has now confirmed these lower court decisions.

What happened?

Although the facts are much more complex, in simple terms, a non-resident shareholder made a share investment of $97 million in a Canadian corporation (Canco I) which in turn invested $67 million in a second Canadian corporation (Canco II). Canco II used the funds to make an investment that declined in value.

1. 2011 SCC 63.
2. **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**.

In 1992, when the shares of Canco II had only nominal value (but PUC equal to the amount invested by Canco I in it), the shares of Canco II were moved within the group to Copthorne I, another Canadian company. In order to simplify the corporate structure of the group, it was decided in 1993 that Canco II and Copthorne I would amalgamate. However, to preserve the PUC of the Canco II shares, they were first transferred to Copthorne I's non-resident parent. Canco II and Copthorne I then amalgamated to form Amalco I. At the same time, the group retained its investment in Canco I, the shares of which had PUC of $97 million.

In 1995, another amalgamation occurred of Amalco I and several other group companies, including Canco I, to form Amalco II. In this amalgamation, preferred shares were issued to a Barbados company that held both the shares of Amalco I and Canco I, having PUC of $164 million (based on the available combined PUC of Amalco I and Canco I). Amalco II then redeemed $142 million of these preferred shares.

Because the redemption amount of $142 million did not exceed the PUC of the shares, there was no deemed dividend subject to Canadian withholding tax (absent the application of the GAAR). However, the Minister assessed withholding tax on the basis that the PUC of the shares should have been reduced by $67 million, being the PUC of Amalco I (and subsequently of Amalco II) attributable to the shares of Canco II, and that there was a deemed dividend of $58 million.

What were the issues?

Two main issues were before the SCC:

- The meaning of "series of transactions" and, in particular, in what circumstances a transaction is undertaken "in contemplation" of another.
- The more general issue of what is abusive "surplus stripping."

For purposes of the GAAR, it is necessary to consider whether a transaction that achieves a tax benefit, or a transaction that is part of a series of transactions that achieves a tax benefit, is primarily motivated by obtaining one or more tax benefits. A specific statutory rule expands the meaning of "series of transactions" to include a transaction that is undertaken "in contemplation of" another transaction or series of transactions.

On the facts, the earlier transactions, in which the shares of Canco II were moved out from under Copthorne I and the PUC of the Canco II shares was "preserved" in the horizontal amalgamation to form Amalco I, were undertaken without any specific plan to rely on that PUC to make a distribution. The taxpayer therefore argued that the preferred share redemption (which produced the tax benefit) was not part of this earlier series of transactions. However, the Minister took a contrary view, which was supported by each of the lower courts.

What did the SCC decide?

In a unanimous decision, the SCC agreed with both of the lower court decisions and dismissed the taxpayer's appeal, although the SCC agreed that on the two amalgamations, no provision of the Act eliminated Canco II's PUC. In other words, the planning technically worked and no provision of the Act required the return of PUC to be treated as a taxable payment, unless the GAAR applied.

However, the SCC confirmed that "in contemplation of" in 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 Canco II were transferred out of Copthorne I, and Copthorne I and Canco II were horizontally amalgamated), this is a sufficient connection to make the earlier and later transactions part of the same series. Although Rothstein J., writing for the Court, acknowledged that the more common use of the term "contemplation" is prospective, such a reading would unduly narrow its scope. Further, in its earlier decision in **Canada Trustco**[3] the SCC had

3. **Canada Trustco Mortgage Co. v. Canada**, 2005 SCC 54.

specifically endorsed both a prospective and retrospective interpretation.

The SCC found that to allow the same cross-border PUC (the $67 "million tax-paid" investment) to be used twice frustrated the purpose of the specific rules that would have cancelled the PUC of Canco II if there had been a vertical amalgamation of Canco II and Copthorne I.

The SCC endorsed its earlier statement in **Canada Trustco** that the GAAR can be applied to deny a tax benefit only when the abusive nature of the transaction is clear. However, it found that it did not need to find a broad policy against surplus stripping in the Act in order to rule against the taxpayer. Rather, it was able to find in the rationale of the PUC scheme, specifically in relation to amalgamations, and an examination of the various PUC rules in the Act, a policy that was frustrated by the transactions that were undertaken.

Need more help?

As the SCC observed, it is relatively straightforward to set out the GAAR scheme but it is much more difficult to decide when it should actually apply. For more information on the implications of this decision and what it means for you or your company, contact any of the following individuals:

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