Current Cases*

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Abstract

The panel participants comment on recent judicial decisions.

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Introduction

Anu Nijhawan: A number of interesting cases that raise diverse issues have been released this year. These issues include the general anti-avoidance rule (GAAR), tax treaty interpretation, rectification, and various procedural matters. We have decided to focus on six key cases: the Federal Court of Appeal's decision in *McGillivray Restaurant* dealing with de facto control;[1] the Tax Court of Canada's decision in *Poulin* and *Turgeon*, dealing with the factual non-arm's-length test;[2] the Tax Court's GAAR decisions in *Oxford Properties*[3] and *Univar*;[4] the Federal Court of Appeal's decision in *Kruger*,[5] dealing with the role of accounting principles in tax; and, if time permits, the Tax Court's decision in *Rio Tinto*,[6] dealing with transaction costs. These cases raise big-picture issues relevant to tax practice and, in our view, potentially extend far beyond their specific factual circumstances. Four of these cases are currently under appeal.

Please note that our comments represent our personal views and do not necessarily represent the views of the Department of Justice or our respective firms. In fact, we are still debating among ourselves some of the issues that these cases raise.

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De Facto Control and De Facto Non-Arm's-Length Dealings

Perry Derksen: Two cases involve de facto control or de facto non-arm's-length dealings: the decision of the Federal Court of Appeal in *McGillivray* and then the decisions of D'Auray J in *Poulin* and *Turgeon*.

McGillivray

Perry Derksen: The terms "de facto" and "de jure" raise the question whether something exists in fact (de facto) or by right or according to law (de jure). *McGillivray* concerns the test for determining who has de facto control of a corporation. In the Act,[7] the term "control" in relation to a corporation is generally taken to refer to de jure control. In contrast to de facto control, de jure control involves whether the controlling party enjoys, by virtue of its shareholdings, the ability to elect the majority of the board of directors.[8]

Subsection 256(5.1), which was added to the Act in 1988, addresses de facto control. For the purposes of the Act, subsection 256(5.1) provides that when the expression "controlled directly or indirectly in any manner whatever" is used, a corporation is considered to be so controlled by another corporation, person, or group of persons if at any time—and here are the key words—"the controller has any direct or indirect influence that if exercised would result in control in fact of the corporation." *McGillivray* raised the question whether certain corporations were associated and required to share the small business deduction. However, because the term "controlled directly or indirectly in any manner whatever" is used throughout the Act in a number of places, the analysis in *McGillivray* has a much broader application—for example, it comes into play in the definition of a Canadian-controlled private corporation in subsection 125(7).

In *McGillivray*, Mr. Howard was the sole shareholder of the corporation GRR Co., which had been operating three restaurants in Winnipeg under franchise agreements. Mr. Howard's decision to relocate one of the restaurants led to the incorporation of McGillivray, the taxpayer. Mr. Howard had 100 percent control of both GRR Co. and another corporation called MorCourt. He had a 24 percent common voting interest in McGillivray, and his wife, Mrs. Howard, had the other 76 percent voting interest. Mr. Howard was elected as the sole director of McGillivray and was appointed as its only officer. He assured the franchisor that everything would be run in the same way as before. McGillivray claimed the small business deduction, and the minister disallowed it on the basis that McGillivray was associated with GRR Co and MorCourt. This raised the question whether McGillivray was under the de facto control of Mr. Howard.

In 2002, the Court of Appeal in *Silicon Graphics* had considered the meaning of de facto control and formulated a test; for there to be a finding of de facto control, a person or group of persons must have the clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise

have the ability to elect the board of directors.[9] In the years that followed, there were two notable decisions that likewise considered the question of who had de facto control of a corporation. One was *Mimetix Pharmaceuticals*, a decision of the Tax Court, which was affirmed by the Court of Appeal.[10] In *Mimetix*, the court considered economic controlling influence, control over the day-to-day operations of the corporation, who was making all of the decisions, who was in an economic position to exert influence, and who was authorized to sign the cheques. The other decision of the Tax Court, *Plomberie J.C. Langlois Inc.*, was also affirmed by the Court of Appeal.[11] In *Langlois*, there were two 50-50 shareholders. One was appointed the sole director, and the court held that that director had de facto control over the corporation because he had the power that ensured him dominant influence over the direction of the corporation.

At the Tax Court level in *McGillivray*, the judge considered *Silicon Graphics*, which had quite a narrow test, along with other cases, including *Mimetix* and *Langlois*; he read them as though he was required to apply a test that included broader considerations. In reading the subsequent decisions and considering broader manners of influence, the judge found that Mr. Howard did indeed have effective de facto control over McGillivray because Mr. Howard had control over the management and operation of the business; Mr. Howard had influence when Mrs. Howard appointed him as a sole director; and, although he recognized that Mrs. Howard could, as the 76 percent voting shareholder, replace Mr. Howard, she did not. In addition, Mr. Howard and Mrs. Howard would have been concerned about the impact on the franchise agreements. The Court of Appeal, however, made it clear that the correct test for de facto control was the test set out in 2002 in *Silicon Graphics*. I think a key takeaway from the Court of Appeal's analysis is that de facto control is concerned with control over the board of directors, and not with control over the day-to-day operations of the corporation.

After the Court of Appeal's decision in *McGillivray*, it is clear that de facto control is not based on operational control. The Court of Appeal said that de facto control is control by some means that falls short of meeting the test for de jure control and that the difference between de facto control and de jure control is limited to the breadth of the factors that can be considered. The Court of Appeal said that the relevant factors remain open but must include a legally enforceable right and ability to effect a change in the board of directors or its powers or a legally enforceable right and ability to exercise influence over the shareholders who have that right and ability.

After clarifying the test, the Court of Appeal went on to consider the facts and concluded that the Tax Court judge had made, in essence, a finding that Mr. and Mrs. Howard had an unwritten agreement that Mr. Howard would control the composition of the board of directors. It therefore dismissed McGillivray's appeal. A few questions remain in relation to the Court of Appeal's statements and analysis in *McGillivray*. Consider, for example, the statement made in the 1988 technical notes when subsection 256(5.1) was introduced.[12] The technical notes referred to an example of de facto control in which a person held 49 percent

of the voting control of a corporation and the balance was widely dispersed among many of the corporation's employees or was held by persons who could reasonably be considered to act in accordance with that person's wishes. How is that going to play out?

Anu Nijhawan: I agree that in many circumstances these cases offer more certainty in the de facto control analysis. But I do struggle with how the Federal Court of Appeal's test applies to the hypothetical in the technical notes, particularly using a purposive interpretation of subsection 256(5.1). On the one hand, the 49 percent shareholder in the hypothetical does not have a legally enforceable right or ability to effect a change in the majority of the board of directors, or to exercise any influence on the other shareholders that would effect such a change. The technical notes make reference to a situation in which it "could reasonably be considered that" the employees will act in accordance with the shareholder's wishes, but it seems to me that that type of expectation falls short of the "legally enforceable test" in *McGillivray*. On the other hand, the 49 percent shareholder in the hypothetical does have a legal right to exercise 49 percent of the votes and, as a practical matter, will likely elect a majority of the directors by virtue of being the strongest voice at the shareholder level. The question is whether that is a sufficient legal right to ground a finding of de facto control. These types of situations are going to take time to sort out in future cases.[13]

Perry Derksen: Practitioners who work with these provisions will also want to consider the implications of subsection 256(2.1), a deeming rule that deems two corporations to be associated if it may reasonably be considered that one of the main reasons for the separate existence of the corporations in a taxation year is to reduce the amount of taxes that would otherwise be payable under the Act. Considering the fact pattern in *McGillivray* in relation to subsection 256(2.1), if that provision were in play, how would it have affected the court's analysis?

Poulin and Turgeon

Perry Derksen: The decisions of D'Auray J in *Poulin* and *Turgeon* concerned de facto non-arm's-length dealings in the context of subsection 84.1(1). At a very elementary level, for subsection 84.1(1) to apply, there must be, in part, a transfer of shares of a corporation by a taxpayer (other than a corporation) to another corporation—and here is the key—with which the "taxpayer does not deal at arm's length." If subsection 84.1(1) applies, there is a deemed dividend instead of a capital gain. The provision therefore raises the question whether a taxpayer does not deal at arm's length with a purchaser corporation. Subsection 251(1) sets out rules for determining whether persons are not acting at arm's length. Paragraph 251(1)(a) contains a rule that concerns related persons who are deemed not to deal with each other at arm's length. What was engaged in *Poulin* and *Turgeon* is paragraph 251(1)(c), which provides that it is a question of fact

whether persons who are not related to each other are, at a particular time, dealing with each other at arm's length. By virtue of paragraph 251(1)(c), *Poulin* and *Turgeon* involve the question of de facto non-arm's-length dealings.

Mr. Poulin and Mr. Turgeon were not related. As a result of share reorganizations in 2005 and 2007, both Mr. Poulin and Mr. Turgeon held some preferred non-voting freeze shares. In 2007, Mr. Poulin disposed of his freeze shares to a corporation that was incorporated by Mr. Turgeon, referred to as "Turgeon Holdco." Likewise, Mr. Turgeon disposed of his freeze shares to Hélie Holdco, a newly incorporated company of Mr. Hélie (an employee of the operating company Amiante). Mr. Hélie was being brought into the ownership of the operating company. The transactions were undertaken to facilitate Mr. Poulin's gradual departure from the operating company and integrate Mr. Hélie as a new shareholder who would also take over the work of Mr. Poulin. Mr. Poulin and Mr. Turgeon reported capital gains on the dispositions of their shares, and both claimed a capital gains deduction on small business corporation shares under subsection 110.6(2.1). The minister disallowed the capital gains deduction on the basis that Mr. Poulin and Turgeon Holdco were not acting at arm's length, but rather were acting in concert without separate interests, and were deemed to have received a dividend under subsection 84.1(1). Likewise, the minister disallowed the capital gains deduction to Mr. Turgeon because Mr. Turgeon and Hélie Holdco were not acting at arm's length on the basis that they were acting in concert without separate interests. The starting point in the Tax Court's analysis involves the three criteria that the courts use to consider whether parties are not acting at arm's length. These criteria have been restated several times and recently by the Supreme Court of Canada in *McLarty*:[14] (1) was there a common mind that directed the bargaining for both parties to the transaction, (2) were the parties to a transaction acting in concert without separate interests (the criterion that the minister used in *Poulin* and *Turgeon*), and (3) was there de facto control by one party over another?

Monica Biringer: If that sounds familiar in terms of Perry's coverage of *McGillivray*, I urge you not to be lulled into thinking that there is a direct connection between the two tests (de facto control and de facto non-arm's-length dealings). The Canada Revenue Agency (CRA) has suggested that there is overlap for the third criterion, although *McGillivray* does constrain the de facto control test. That does not necessarily have much significance for the factual non-arm's-length test because there are three tests for de facto non-arm's-length dealings; and we have seen in many of the cases, and somewhat similarly in this case, that the criteria are often merged and treated as if they are all part of the same overarching inquiry that is made in the context of factual non-arm's-length dealings.

Perry Derksen: The Tax Court provided a checklist of the indicia of acting in concert without separate interests, and in particular whether the parties are acting for their own benefit or for someone else's. What is important in these criteria is that the relationship between the parties be examined in light of all of the relevant

facts. In *Poulin* and *Turgeon*, the court found that Mr. Poulin and Turgeon Holdco were not acting in concert without separate interests; they were acting at arm's length. In contrast, the court found that Mr. Turgeon and Hélie Holdco were acting in concert without separate interests; they were found not to be acting at arm's length. Therefore, Mr. Poulin's appeal was successful and Mr. Turgeon's was not. Mr. Turgeon has appealed to the Court of Appeal.

Why the distinction? We have tried to distill observations from the court's analysis that might be useful. D'Auray J started her analysis by considering the purpose of section 84.1. She cited other authorities that found the purpose of section 84.1 was to prevent taxpayers from performing transactions whose goal was to strip a corporation of its surplus tax-free through the use of a tax-exempt margin or a capital gains exemption. This purpose guided the court's finding, or the contrast between the results in the two cases. Mr. Poulin was negotiating something more than the capital gains exemption in the deal that he negotiated with Mr. Turgeon. Mr. Poulin wanted to leave the company in a way that allowed him to use the capital gains exemption. Even though it took five years for Mr. Poulin to leave, there was an overarching commercial element to his transaction. Mr. Turgeon was taking control of the operating company, and the court seemed to find that he was negotiating the ability to use the capital gains exemption by having Mr. Hélie, the employee, buy his freeze shares. The freeze shares were paid for by redeeming those shares and sending the proceeds from Hélie Holdco to Mr. Turgeon. When the Tax Court heard the decision, a number of years after the transactions, the shares had not all been paid for, and certain shares were transferred to another corporation that was controlled by Mr. Turgeon. The court found that Mr. Hélie was acting as an accommodator and that the transactions were motivated by the capital gains exemption. Mr. Hélie did not actually receive anything and did not take any real risks.

Monica Biringer: Often, these non-arm's-length cases are so fact-specific that they do not provide much guidance for future cases, but I think that this one is a little different. It has provided the list of criteria that Perry has mentioned, which elaborates on what the court found to be particularly relevant. In addition, the sharp contrast between the two different fact situations within one case distinguishes between a situation in which there are clearly competing commercial interests on the one hand, and a situation in which there is nothing more than an accommodation on the other. The other clarifying point is the idea that common purpose is not the same thing as common interest. Some earlier decisions have muddied the waters between common purpose and common interest. Common interest leads to a factual non-arm's-length finding, but common purpose can mean the common objective of conducting a transaction, which in this case was found not to give rise to common interest. The fact that one party has a tax structure in which the other party is invited to play a role or the fact that both parties are represented by the same advisers may suggest common purpose but does not necessarily amount to common interest.

Perry Derksen: It is important not to lose sight of what is relevant in the context of the section of the Act that is in play, and I think that was a significant factor in the court's analysis.

GAAR Decisions

Monica Biringer: GAAR cases are generally interesting from two perspectives at least. Typically, the court goes into a helpful and in-depth analysis of the object, spirit, and purpose of the provisions of the Act that the Crown has alleged have been misused or abused. We therefore learn about the provisions and gain insight into a certain aspect of the Act. Additionally, we see how a particular GAAR case fits into the developing body of GAAR case law. It has been almost 30 years since GAAR was introduced, and I think that there is still evolution in how the courts approach these cases. The matter of principle that arises in *Oxford Properties* and *Univar* is the effect of a subsequent legislative amendment. What often happens in the context of GAAR cases is that a taxpayer undertakes a transaction, the Department of Finance does not like the transaction, legislation is introduced several years later, the CRA decides to invoke GAAR, and it proceeds with litigation against taxpayers who have completed transactions that, had they been undertaken later, would have been prohibited under the new legislation.

The issue in these cases for the taxpayers who successfully completed the transaction and satisfied the relevant technical provisions of the Act is the role of the subsequent legislative amendment. Is it relevant in determining the object, spirit, and purpose of the provisions that the Crown alleges have been misused or abused? And are the explanatory notes that accompany the subsequent legislative amendment relevant? I like to start with *Dynar*,[15] a Supreme Court case that is not GAAR-related but that makes a very interesting observation in the context of subsequent legislative amendments. It basically says that subsequent enactments reveal the interpretation that the present Parliament places on the work of its predecessor.

Oxford Properties

Monica Biringer: In *Oxford Properties*, the taxpayer's predecessor (old Oxford) was subject to a takeover by BPC in 2001. Before the takeover, old Oxford did some prepackaging of real property (low adjusted cost base and high fair market value) by transferring the property into limited partnerships under subsection 97(2). After the takeover, old Oxford was amalgamated with its immediate parent to form the taxpayer, OPGI. On the amalgamation, there was a bump of the partnership interests under paragraph 88(1)(d). As a result, OPGI held interests in the partnerships that had their adjusted cost base bumped to the fair market value at the time of the takeover. A few years later, new partnerships were formed and the first-tier partnerships transferred their real property into the

second-tier partnerships under subsection 97(2). The first-tier partnerships were dissolved under subsection 98(3), and the basis of the partnership interests was increased under subsection 98(3). OPGI then held the partnership interests in the second-tier limited partnerships that had an adjusted cost base that reflected the historic fair market value at the time of the takeover. OPGI sold the partnership interests to tax-exempt corporations when each of the partnerships owned real property with significant accrued gains and latent recapture. The partnerships could be dissolved by the tax-exempt corporation, and the gains and recapture could in theory leave the system.

The CRA applied GAAR and reassessed OPGI, treating it as having realized a capital gain on the tax-exempt sales. (Some other sales of partnership interests were made to taxable corporations, and the CRA did not apply GAAR to those sales.) The Crown alleged that there was misuse or abuse of subsection 97(2), paragraphs 88(1)(c) and (d), subsection 98(3), and subsection 100(1). The court conducted a careful analysis of each of the relevant provisions. The taxpayer had already conceded that it obtained a tax benefit. The court essentially concluded that the prepackaging, bump, and sale to the tax-exempt entities were all part of the same series. The real issue therefore became whether there had been misuse or abuse of the relevant provisions. The court appeared to pay particular attention to the fact that the CRA did not assess the sales to the taxable entities, restricting the focus of its GAAR analysis to the sales to the tax-exempt entities. The court established that there was no misuse or abuse of the relevant provisions. In particular, it looked at subsection 69(11), an anti-avoidance rule that applies when advantage has been taken on a sale to a tax-exempt entity within three years of the use of a rollover provision. The court examined the three-year bright-line test in subsection 69(11) to inform its analysis with respect to subsection 97(2) and found that there had been no misuse or abuse. The court also examined the addition of subparagraph 88(1)(d)(ii.2), which restricts the amount by which partnership interests can be bumped to the amount of the partnership's fair value not attributable to depreciable property or other types of ineligible property. This is the subsequent legislative amendment made in 2012 to which I referred earlier.

The court analyzed all of the relevant provisions, found that there had been no misuse or abuse, and found that GAAR did not apply. The case is currently under appeal. In summary terms, the basis of the appeal is that the court erred in its analysis of the object, spirit, and purpose of each provision that it examined and also erred in concluding that the addition of subparagraph 88(1)(d)(ii.2) represented a change in policy and therefore was not relevant to the GAAR analysis.

Anu Nijhawan: A ground of appeal was that there was an error in determining misuse or abuse without having regard to the overall result of the transactions. As Monica described, the Crown had argued that there was a broader purpose of the provisions of the Act that prohibited the direct or indirect bumping of depreciable property. The Tax Court explicitly referred to the relevance of the

overall result but then appeared to analyze the policy and purpose of each provision independently. The Tax Court looked first at subsections 97(2) and 69(11) as a group of rules, then at paragraph 88(1)(c), and then at subsection 98(3) as another set of rules. In a very detailed analysis, the Tax Court examined the purpose of each of these provisions and concluded that the transactions did not frustrate any of those individual purposes; therefore, GAAR did not apply. One of the Crown's arguments on appeal was that the result of the transactions should have been taken into account in its totality. In other words, what was the combined purpose of the provisions in question, and was that combined purpose frustrated? One response might be that the court did consider the scheme of the Act as a whole, as demonstrated by the fact that it used subsection 69(11) to inform the subsection 97(2) analysis and explicitly referred to the overall results of the transactions. The other side of the argument is that there was no explicit consideration of the policy of the totality of the provisions, which should have been discussed. The result (the finding that GAAR does not apply) will not necessarily change, but it will be interesting to see the analytical approach that the Federal Court of Appeal takes to resolve this issue.

Univar

Monica Biringer: *Univar* addresses the question whether there had been a misuse or abuse of section 212.1 and subsection 212.1(4). At issue in the case was the taxpayer's access to subsection 212.1(4) in the context of an arm's-length acquisition. Subsection 212.1(4) is an exception to section 212.1. At the relevant time, it provided an exception to section 212.1 if the disposition of the Canadian company's shares was to a Canadian purchaser that controlled the non-resident seller of shares.

Univar dealt with the making and unmaking of a "sandwich" in the context of an arm's-length transaction. A UK corporation acquired all of the shares of a Dutch company, Univar. Univar had a Canadian operating company owned through two US companies. The shares of the Canadian company had low paid-up capital (PUC), low basis, and high fair market value. After the transaction took place, the two US companies amalgamated, which resulted in a gain triggered on the shares of the Canadian company. The gain was exempt under the Canada-US treaty.[16] The shares of the US company that held the Canadian company were transferred down the chain into a Canadian company, thus creating a sandwich (a Canada-US-Canada sandwich). When the shares of the US company were transferred, section 212.1 was not operative because the shares were of a US company, even though they derived a significant portion of their value from the shares of a Canadian company.

The sandwich was then unmade. When the shares of the Canadian company were transferred out of the US company (on a redemption of shares), the transaction fell within subsection 212.1(4) because the US company was transferring the shares of the Canadian company (with high basis and low PUC) to the Canadian

parent of the US company. The transaction was in compliance with subsection 212.1(4), but it was ultimately found to be objectionable. The US company was also sent up through the chain, resulting in a Canadian holding company whose sole asset was the Canadian operating company, and the Canadian holding company had cross-border tax attributes—that is, the PUC of the shares and a note that together equalled the fair market value of the company. At that point, the Canadian holding company was able to distribute the full value of the underlying Canadian operating company free of withholding tax. The CRA assessed under GAAR to deem a dividend equal to the amount of the note and reduce the PUC of the shares to a nominal amount on the basis that there was nominal PUC and the taxpayer should not be allowed to gain access to subsection 212.1(4) because that would violate the object, spirit, and purpose of subsection 212.1(4) and the scheme inherent in section 212.1.

In coming to its conclusion, the court focused on these two provisions and determined that section 212.1 and subsection 212.1(4) had been misused or abused. The court concluded that the purpose of section 212.1 was to prevent Canadian subsidiaries from converting dividends that would attract withholding tax into capital gains, a result that the taxpayer had been able to achieve. The court also considered subsection 212.1(4). In ascertaining its object, spirit, and purpose, the court was challenged because the subsection was introduced in 1977 and no contemporaneous information was available 40 years later. The court looked to a private commentary[17] for some assistance. Most importantly, it also considered a subsequent amendment to subsection 212.1(4) that was proposed after the hearing and on which the parties did not get a chance to make submissions. The amendments to subsection 212.1(4) were quite extensive. They changed a number of the features in subsection 212.1(4), which was a generous, broadly worded exemption, and added a number of constraints, not the least of which was the limitation that the provision does not apply when there is an indirect or direct shareholding by a non-resident.

The court placed a high degree of reliance on the subsequent amendment, and in particular on the explanatory notes to it. The explanatory notes refer to the measure as being clarifying.[18] The court seized on that statement and found that the amendment was clarifying and that it was relevant that the taxpayer would have been captured by the amendment had the transaction been completed later. In other words, the fact that the taxpayer would not have been entitled to rely on the amended exception in subsection 212.1(4) had it been in force at the relevant time led the court to conclude that there had been a misuse or abuse.

The taxpayer argued that it could have used what is commonly referred to as the "Tax 101" way of acquiring a Canadian company and achieved the same result by having a fully capitalized Canadian acquisition company buy the Canadian company. If that had been done, it could have achieved cross-border capital and other attributes directly. Why can the taxpayer not do indirectly (by making and unmaking the sandwich contemporaneously with the arm's-length acquisition) what it could have done directly? It has not bumped up the cross-border PUC/ tax attributes to anything more than it could have obtained had the acquisition

been structured that way. Why is the transaction considered to be abusive when the same result could have been achieved in a way that no one would consider abusive?

The case is under appeal. The grounds for appeal are the court's failure to consider this argument and the court's response that the taxpayer did not use a Canadian acquisition vehicle and that the form of the transaction matters. My favourite stated ground for appeal is that the judge relied on a statement of legislative intent in the explanatory notes that was made 40 years after the enactment of section 212.1 and nine months after the hearing.

Anu Nijhawan: I think that special focus should be placed on the court's comment that in tax law "form matters." While we all agree that form matters, if form were always determinative, there would be no need for GAAR. In applying GAAR, the Supreme Court has told us to step back from the form of the transaction and to determine instead whether the transaction results in a frustration of the policy of the provisions of the Act. Monica has described the Tax 101 transaction, which would have resulted in full cross-border PUC. This type of planning has long been thought to be legitimate, and many writers have contended that such legitimacy is supported by the existence of the PUC offset rules in the foreign affiliate dumping regime. I would have thought that the policy of the provisions and the issues should be the same, irrespective of the form of the transaction. If taxpayers can preserve cross-border PUC using a Canadian acquisition company to acquire a Canadian target, then why is the policy of the Act, before the amendment to subsection 212.1(4), to prohibit this when the Canadian company is an indirect target? Many explanations have been suggested, but the Tax Court did not provide an analysis. We will have to wait for the Federal Court of Appeal to tell us why, if taxpayers can do something directly, GAAR applies when they do it indirectly.

Monica Biringer: *Oxford Properties* and *Univar* come to quite interesting and different results on the subsequent legislative amendment. In *Univar*, the court states that the Act was amended to clarify that the subsection 212.1(4) exception was unavailable in the conditions that are now prescribed. In the context of the subparagraph 88.1(d)(ii.2) amendment relevant in *Oxford Properties*, the budget stated that specific legislative action was required to explicitly prohibit the use of similar structures. In *Oxford Properties*, the judge decided that the amendment reflected the adoption of new policy, and therefore GAAR was not invoked. In *Univar*, the court concluded that the legislative amendment embodied the underlying rationale that was already there—the unexpressed legislative intention that is so often at issue in GAAR cases.

Perry Derksen: In *Gwartz*, Hogan J of the Tax Court stated that a subsequent amendment must be considered, along with all other relevant materials, to ascertain the object, spirit, and purpose of the provisions.[19] He noted that in certain circumstances a subsequent amendment may suggest that the provision's rationale

or object, spirit, and purpose was frustrated by the tax-avoidance strategy. But in other circumstances, Hogan J said, Parliament may have changed its mind and intended to prevent something that initially it did not intend to capture with the provision. Arguments are made that a subsequent amendment reflects a change in policy as opposed to the closure of an unintended loophole or the elimination of a provision that is inconsistent with the underlying rationale. The question is whether the amendment tells us anything about the object, spirit, and purpose of the pre-amendment provision at issue—for example, does the subsequent amendment represent a change in policy from the pre-amendment policy of the provision? It is also important to consider the underlying rationale of the statutory provisions as they existed at the time of the transactions.

Monica Biringer: In *Oxford Properties*, the court examined the subsequent legislative amendment and concluded that it was new policy. The court seems to have been influenced by what it considered to be substantial changes in the ability to bump a partnership interest, regardless of whether the purchaser is taxable or tax-exempt. The court looked at both the old legislation and the new legislation.

Univar does not provide a deep analysis of the proposed amendments, nor does it investigate whether these amendments reflect a change of policy. The amendments to subsection 212.1(4) are quite far reaching, and it is not clear how they reflect the legislative scheme as it existed before they were enacted. The court seems to rely on the text of the explanatory notes.[20] We hope that the Federal Court of Appeal is clear on the impact of a GAAR analysis of a subsequent legislative amendment. How does the subsequent legislative amendment inform the object, spirit, and purpose of the legislation that is in force and at issue under the application of GAAR? Further, if the subsequent legislative amendment is relevant, what relevance do the technical notes have? Are they irrelevant, somewhat relevant, or determinative? We will see.

Kruger

Anu Nijhawan: The Federal Court of Appeal's decision in *Kruger* directly addresses the role of accounting principles in computing business profits under section 9. At issue was the application of the mark-to-market accounting method as opposed to the realization method. Very basically, the mark-to-market accounting method is an accrual method whereby the property is initially valued and any change in the market value is recognized as a gain or loss for the period. In contrast, the realization method requires that business profits and losses must be realized to be recognized for tax purposes.

Kruger Incorporated was a manufacturer of newsprint and other paper products. To reduce exposure to foreign currency fluctuation, it had developed an expertise in buying and selling foreign currency option contracts. The Tax Court reviewed evidence that revealed the following: (1) the option activity constituted

an independent profit centre, (2) there was no intention to hedge foreign currency exposure with respect to the paper business, (3) the option-related operations had four or more employees with expertise in the area, and (4) the financial results of the option activities were recorded separately from the paper business. On the basis of this evidence, the Tax Court concluded that the taxpayer carried on a separate business of speculating in foreign currency options.

The question before both levels of court was whether the options could be valued using a mark-to-market method in computing income, either under section 9 or because the options constituted inventory and thus could be valued under subsection 10(1). Because the Canadian dollar had fallen in relation to the US dollar in the applicable tax year, the mark-to-market value gave rise to an increase in income of about $72 million. In contrast, if the taxpayer was forced to use the realization method, the accrued losses in respect of the options could not have been claimed until the options were disposed of or exercised in the following year.

We are going to be focusing on the section 9 analysis. The Crown's argument was essentially that in the absence of a statutory rule to the contrary, the realization method should prevail. The Federal Court of Appeal began its analysis with a review of *Canderel*,[21] *Ikea*,[22] and *Toronto College Park*.[23] It reiterated the principle that a taxpayer's method of computing profit must be consistent with the provisions of the Act, the established case law, the rules of law, and well-accepted business principles. Further, the method must provide an accurate picture of income.

The Federal Court of Appeal went on to hold that it was clear from these decisions that the realization method can give way to other methods of computing income pursuant to section 9, as long as the other methods can be shown to provide a more accurate picture of the taxpayer's income for the year. The court then noted that the evidence demonstrated that the mark-to-market method was consistent with both US and Canadian generally accepted accounting principles, (GAAP) and that the option valuation evidence was reliable. On that basis, the court found that the mark-to-market method could not be excluded as an acceptable method of computing income.

Once the taxpayer had established prima facie that the mark-to-market method provided an accurate picture of income, the onus shifted to the Crown to show that the realization method produced a more accurate picture. On the facts of the case, because the Crown had focused its argument on the fact that the mark-to-market method was inappropriate, it did not adduce any evidence to show whether the realization method might have produced a more accurate picture of income.

In the result, the taxpayer's appeal was allowed, and it was permitted to use the mark-to-market method and claim the resulting loss.

This case might be read as turning on its head the notion that realization is an overarching principle. A broad reading of the decision suggests that a taxpayer can use an alternative method of computing income as long as it provides

a more accurate picture of income and is not explicitly excluded under the Act. The case seems to allow a taxpayer that has acquired property on income account to report its gains or losses on a mark-to-market basis if it prepares its financial statements in accordance with GAAP, provided that the approach is consistent and is not prohibited under a specific provision of the Act. In other words, a broad reading suggests that the realization method has no inherent priority over any other methodology. In reaching this conclusion the court reviewed and relied on *Canadian General Electric*,[24] which dealt only with unrealized foreign exchange gains; therefore, the unresolved question is whether *Kruger* applies in a context beyond foreign exchange derivatives.

Perry Derksen: After the Tax Court's decision in *Kruger*, amendments were introduced in subsection 10(15) to provide that certain derivatives are deemed not to be inventory of a taxpayer and to introduce paragraph 18(1)(x) to prohibit the deduction of any reduction, in part, in the value of certain derivatives if the taxpayer uses the lower of cost and value method. The amendment has just passed second reading, and I think it is now at the committee stage.[25] It raises the question whether this is the end of the matter.[26]

Anu Nijhawan: I think that question is going to have to be determined in the future.

Although the court's decision on the mark-to-market point was arguably sufficient to dispose of the appeal, it went on to consider, in the alternative, whether the options constituted inventory. While the Act is premised on the existence of two types of property, inventory and capital property, I think the big takeaway is that property may exist that is neither inventory nor capital property.

Rio Tinto

Anu Nijhawan: At issue in *Rio Tinto* was the deductibility of approximately $100 million in transaction expenses that the taxpayer had incurred in the course of two related transactions: one was a public corporate acquisition of a French aluminum company, and the other was a spinoff of certain assets mandated by competition authorities as a condition of the takeover. Because *Rio Tinto* is being discussed in another session, our comments here are brief.

The main item arising from the decision is the court's adoption of a bright-line test in determining whether expenses were on account of capital or were deductible as being on income account. Hogan J began his analysis by dividing the transaction expenses (consisting of investment banking fees, public relations costs, legal and accounting fees, and printing costs) into two groups. The first group involved oversight expenses, which are fees for services that assist a board of directors in deciding whether or not a transaction should be approved as part of its oversight function. The second group involved execution costs, which are fees for services that facilitate the execution of a capital transaction. The court

then reviewed the main judicial tests for distinguishing a capital outlay from a current expense. Although the court did not mention the analysis in *BJ Services*[27] or *International Colin*,[28] its comments confirm the reasoning in these cases in explicitly recognizing the importance of the board of directors' role in determining whether or not to proceed with a transaction and allocating capital resources. It concluded that oversight expenses are current expenses, while execution costs are capital outlays. The court gave further support to the view that just because expenses are incurred in the context of a capital transaction, these expenses are not necessarily denied as being on capital account. In analyzing the category into which a particular expense fell, the court looked to the primary purpose of the work performed: whether the expenses were incurred primarily to assist in the oversight or management process or whether they were primarily linked to the implementation of the transaction carried out on capital account. On the facts of the case, the court appears to have adopted a bright-line test, wherein costs for general advisory services and due diligence efforts incurred before the offer was publicly announced constituted oversight expenses and were therefore deductible under section 9, whereas other costs incurred after that date were execution costs. These latter costs included tax structuring related to the implementation of the transaction and the post-closing organization, preparation, and delivery of information and circulars. The Crown has filed an appeal with respect to the expenses allowed as oversight expenses, and the taxpayer has cross-appealed with respect to printing and issue costs for financial reports.

Notes

1 *McGillivray Restaurant Ltd. v. Canada*, 2016 FCA 99; aff'g. 2014 TCC 357.

2 *Poulin v. The Queen*, 2016 TCC 154 (heard on common evidence with *Turgeon v. The Queen*) (currently on appeal to the Federal Court of Appeal).

3 *Oxford Properties Group Inc. v. The Queen*, 2016 TCC 204 (currently on appeal to the Federal Court of Appeal).

4 *Univar Holdco Canada ULC v. The Queen*, 2016 TCC 159 (currently on appeal to the Federal Court of Appeal).

5 *Kruger Incorporated v. Canada*, 2016 FCA 186.

6 *Rio Tinto Alcan Inc. v. The Queen*, 2016 TCC 172 (currently on appeal to the Federal Court of Appeal).

7 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

8 *Duha Printers (Western) Ltd. v. Canada*, [1998] 1 SCR 795, at paragraph 35.

9 *Silicon Graphics Ltd. v. Canada*, 2002 FCA 260, at paragraph 67.

10 *Mimetix Pharmaceuticals Inc. v. The Queen*, 2001 CanLII 787 (TCC); aff'd. 2003 FCA 106.

11 *Plomberie J.C. Langlois Inc. c. La Reine*, 2004 TCC 734; aff'd. 2006 FCA 113.

12 Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Department of Finance, June 1988), at subclause 193(3).

13 After the panel discussion, the 2017 federal budget proposed to amend the Act to clarify that in determining whether factual control of a corporation exists, factors other than the "legally

enforceable test" may be considered. This indicates that from a policy perspective the government did not intend that the factual control test be dependent on the existence of a legally enforceable right or that factors that do not include such a right should be disregarded.

14 *Canada v. McLarty*, 2008 SCC 26, at paragraph 62.

15 *United States of America v. Dynar*, [1997] 2 SCR 462.

16 Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

17 *1977 De Boo Budget Date Comments* (Toronto: De Boo, March 1977).

18 Canada, Department of Finance, 2016 Budget, Tax Measures: Supplementary Information, March 22, 2016, at 50.

19 *Gwartz v. The Queen*, 2013 TCC 86, at paragraphs 54-57.

20 Supra note 17.

21 *Canderel Ltd. v. Canada*, [1998] 1 SCR 147.

22 *Ikea Ltd. v. Canada*, [1998] 1 SCR 196.

23 *Toronto College Park Ltd. v. Canada*, [1998] 1 SCR 183.

24 *Canadian General Electric Company v. The Minister of National Revenue*, [1962] SCR 3.

25 Now implemented as the Budget Implementation Act, No. 2, SC 2016, c. 12; royal assent December 15, 2016.

26 After the panel discussion, the 2017 federal budget proposed two measures to clarify the timing of recognition of gains and losses on derivatives, including an elective mark-to-market regime for derivatives held on income account.

27 *BJ Services Company Canada, the Successor to Nowsco Well Service Ltd. v. The Queen*, 2003 TCC 900.

28 *International Colin Energy Corporation v. The Queen*, 2002 CanLII 47015 (TCC).