Docket: 2008-2482(IT)G

BETWEEN:

1207192 ONTARIO LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on December 1 and 2, 2010, at Toronto, Ontario

Before: The Honourable Justice B. Paris

Appearances:

Counsel for the Appellant:	Matthew G. Williams Mark A. Barbour
Counsel for the Respondent:	Marta E. Burns Margaret McCabe

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the taxation year ending February 28, 2003 is dismissed, with costs.

Signed at Ottawa, Canada, this 7th day of September 2011.

"B.Paris"

Paris J.

Citation: 2011 TCC 383
Date: 20110907
Docket: 2008-2482(IT)G

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1207192 ONTARIO LIMITED,

Appellant,

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REASONS FOR JUDGMENT

Paris J.

[1] This is a reassessment of the Appellant's taxation year ending February 28, 2003. The Minister of National Revenue applied the General Anti-Avoidance Rule ("GAAR") in subsection 245(1) of the *Income Tax Act* [1] to deny the capital loss of $2,999,900 realized by the Appellant on the disposition of the common shares it held in 2022900 Ontario Inc. ("Newco")

[2] The loss on the common shares was generated by the declaration of a stock dividend by Newco on the common shares prior to the disposition by the Appellant. The payment of the stock dividend had the effect of decreasing the value of the Appellant's common shares in Newco by an amount equal to the value of the stock dividend. The stock dividend consisted of preferred shares with a low paid-up capital and a high redemption amount. The transfer of value from the common shares to the preferred shares was referred to by Respondent's counsel as a "value shift." After the payment of the stock dividend, the Appellant's loss on the common shares was crystallized by a disposition of those shares to a family trust of which the

[1] R.S.C., 1985, c. 1 (5th Supp.))

beneficiaries were family members of the sole shareholder of the Appellant, Mr. Dan Cross.

[3] The capital loss was used by the Appellant to offset a capital gain of $2,974,386 it realized during its 2003 taxation year.

Issues

[4] In order for the GAAR to apply: there must be:[2]

> -a tax benefit resulting from a transaction or series of transactions of which the transaction forms a part; (s. 245(1) and (2));
>
> -the transaction must be an avoidance transaction in the sense that it cannot be said to have been reasonably undertaken or arranged primarily for a *bona fide* purpose other than to obtain a tax benefit; and
>
> -there must be abusive tax avoidance in the sense that it cannot be reasonably concluded that the tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

[5] In this case, the Appellant concedes that it obtained a tax benefit as a result of the series of transactions that gave rise to the capital loss. At issue is whether there was an avoidance transaction, and if so, whether there was abusive tax avoidance.

[6] The Appellant maintains that none of the transactions that resulted in the capital loss were undertaken primarily to obtain the tax benefit. It says that the primary purpose of those transactions was to creditor-proof Mr. Cross, who at the time of the transaction was about to embark on a financially risky venture. The Appellant also says that there was no abusive tax avoidance because the tax benefit is consistent with the object, spirit and purpose of the provisions of the *Act* relied upon by the Appellant.

Background

[7] Mr. Cross has worked in the life insurance industry for many years. He started out as a salesman and later became a broker. In 1987, he and a partner started Bridan Insurance, which operated as a managing general agent ("MGA").

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[2] *Canada Trustco Mortgage Co. v. R.*, 2005 SCC 54, [2005] 2 S.C.R. 601 at paras 18, 21 and 36.

An MGA acts as a middleman between insurance companies and independent insurance brokers and earns commissions from the insurance companies on insurance products sold by the brokers. Bridan Insurance operated until some time around 1990, after which Mr. Cross and a different partner started another MGA business called Brokerage Underwriting Services.

[8] In the early 1990's, Mr. Cross was pursued by a creditor in relation to certain personal guarantees he had given on behalf of his partner in Bridan. As a result, he declared bankruptcy. In those proceedings, his creditor sought to set aside Mr. Cross' transfer of his interest in the family home to his spouse that had taken place the year prior to his declaring bankruptcy. The trustee determined that the conveyance was not done to defeat creditors and Mr. Cross' spouse was able to keep the home. However, Mr. Cross said that the possibility of losing the home had caused him and his spouse a great deal of stress. Mr. Cross was discharged from bankruptcy in 1995.

[9] Through the late 1990's, Brokerage Underwriting Services, which Mr. Cross and his partner continued to operate, prospered.

[10] In 1999, Mr. Cross and his partner sold their shares in Brokerage Underwriting Services to an arm's length purchaser, Hub Insurance Group ("Hub"), in exchange for shares in Hub. Mr. Cross transferred his Hub shares to the Appellant using the provisions of section 85 of the *Act*.

[11] Mr. Cross was given a 10-year employment contract by Hub, but he retired in 2002 due to back problems. The Appellant disposed of its Hub shares between July and October 2002, realizing a capital gain of $2,974,386.

[12] After retiring from Hub, Mr. Cross, along with Mr. Robert Young and Mr. Shawn Comiskey, decided to start up an MGA business called Success Strategies Inc. (SSI). Their intention was to sell high-face value life insurance policies on behalf of AIG Life of Canada ("AIG") through a limited number of brokers to wealthy individuals. The policies were expected to have high premiums and to generate large commissions for the brokers and for SSI. These policies would be subject to chargebacks if a client cancelled the policy or did not pay the required premiums at any point in the first two years of the policy. If either event occurred, the insurance company writing the policy could collect back some or all of the commission that had been paid to the broker and to the MGA. The amount of this chargeback would depend on how long the policy had been in force and the amount of the premiums that had already been paid. In this case, AIG required

guarantees from SSI and from Mr. Cross, Mr. Young and Mr. Comiskey personally for the payment of any chargebacks.

[13] Mr. Cross testified that Mr. Young and Mr. Comiskey had limited resources at the time SSI was starting up. This meant that if any claims were made against SSI, he would have to pay them himself because he was the only one with any money. In addition guaranteeing the debts of SSI to AIG, Mr. Cross also guaranteed SSI's line of credit with the bank. Mr. Cross said that he and his wife were very concerned about his exposure under these guarantees because his previous bankruptcy had resulted from claims arising from personal guarantees he had given.

[14] Mr. Cross said that these concerns led him to contact Mr. Doug Marshman at Deloitte and Touche to obtain advice on possible creditor-proofing strategies.

[15] Mr. Marshman testified that at their first meeting in the fall of 2002, he and Mr. Cross discussed the latter's concerns about his exposure under the SSI guarantees. They also discussed Mr. Cross estate planning in general. He said that they "really didn't discuss any tax issues".

[16] Mr. Marshman said that later on he recalled a partner having discussed a particular creditor-proofing plan at a partner's meeting, and so he obtained a copy of the plan along with the legal opinion relating to the plan. The plan outlined a series of transactions that were substantially the same as those that were carried out by Mr. Cross and the Appellant, and discussed the tax outcomes of the transactions. One of the tax outcomes mentioned was the creation of "a substantial capital loss."

[17] Both Mr. Cross and Mr. Marshman testified that the plan was selected for its creditor-proofing aspect and not because it resulted in a capital loss. Mr. Cross also said that if he had to choose between a plan that provided creditor-proofing and one that resulted in a capital loss, he would have chosen the former. Mr. Marshman testified that he only realized that this creditor-proofing plan would generate a capital loss to the Appellant at the time that a particular Deloitte in-house technical memorandum on the file was produced on January 28, 2003. He said he was pleasantly surprised by this result. The technical memorandum refers to the "creditor-proofing reorganization that is currently in progress" for Mr. Cross. Therefore, according to Mr. Marshman's testimony, he only realized that a capital loss would be produced for the Appellant after the decision to use the plan had been made.

[18] The parties filed a Statement of Agreed Facts at the hearing, and the specific transactions that were carried out are described in paragraphs 7 to 15 thereof, which are reproduced here;

> 7. On February 20, 2003, 2022900 Ontario Inc. ("Newco") was incorporated. Mr. Cross was the sole director of Newco at all material times.
>
> 8. The authorized capital of Newco is unlimited numbers of Class A special shares, Class B special shares and common shares, with the following attributes:
>
> (a) the Class A special shares had no dividend entitlement but had a voting entitlement of 10 votes per share. These shares were redeemable at the amount of their stated capital. In the event of a wind-up or liquidation of the corporation, the Class A special shares ranked ahead of the common shares for payment but payment was limited to the amount of the stated capital;
>
> (b) the Class B special shares while owned by the initial owner were entitled to non-cumulative dividends at the discretion of the directors. Otherwise their dividend entitlement was 6% of stated capital. They had paid up capital ("PUC") of $100 and were redeemable from the initial owner for $100 per share. Other than for the initial owner the redemption amount was the stated capital of the shares plus any unpaid dividends. They were retractable for the amount of their stated capital. In the event of wind-up or liquidation of the corporation, the Class B special shares ranked ahead of all other shares for payment but payment was limited to the amount of their stated capital. These shares were non-voting; and
>
> (c) the common shares were entitled to dividends at the discretion of the directors, even in preference to other classes of shares. Each common share bore one vote.
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> 9. On February 25, 2003, the Cross Family Trust was founded:
>
> (a) Ruth Cross (Mr. Cross' mother) was the settlor;
>
> (b) the object settled was a gold coin;
>
> (c) the Cross Family Trust was established as a discretionary trust; and
>
> (d) Marylee Cross (Mr. Cross' wife), Robert Lesperance (Mr. Cross' brother-in-law) and Paula Adams (Mr. Cross' lawyer) were the

trustees. The trustees made decisions for the trust according to majority rule. The income and capital beneficiaries of the Cross Family Trust were Marylee Cross and the couple's children, Laura and Amy.

10. On February 25, 2003, the Cross Voting Trust was founded:

    (a) Ruth Cross was the settlor;

    (b) The object settled was a $100 bill;

    (c) The Cross Voting Trust was established as a discretionary trust; and

    (d) Mr. Cross, David Cross (Mr. Cross' brother) and Daniel Skellett (Mr. Cross' friend) were the trustees. The appointment of the trustees had to be approved by the director of the Appellant, being Mr. Cross. The trustees made decisions for the Cross Voting Trust according to majority rule. Marylee Cross, Laura Cross and Amy Cross were both income and capital beneficiaries of the Cross Voting Trust. Mr. Cross was an income beneficiary.

11. On or about February 26, 2003, the Appellant purchased marketable securities worth $2,847,505. It also retained $152,495 in cash to establish a block of assets with a total fair market value ("FMV") of $3,000,000.

12. On February 27, 2003, the Appellant transferred its cash and securities with a FMV of $3,000,000 to Newco and was issued from treasury 30,000 common shares in Newco with a stated capital of $2,999,900.

13. On February 27, 2003, Newco declared a stock dividend of 1 Class B special share per common share. The Appellant received 30,000 Class B special shares with a redemption value, to the initial investor, of $3,000,000 and PUC/ACB of $100.

14. On February 27, 2003, the Cross Voting Trust subscribed for 10,000 Class A special shares in Newco and paid $100 for these shares. This purchase gave the Cross Voting Trust 100,000 votes with respect to Newco and, thus, control of Newco.

15. On February 28, 2003, the Appellant sold its 30,000 common shares in Newco to the Cross Family Trust for $100.

[19] The creditor-proofing of Mr. Cross' assets was accomplished through the restriction on the redemption value of the Class B special shares for anyone other

than the initial owner. The Appellant was entitled to have those shares redeemed by Newco for $100 per share, but for any subsequent owner of the shares, the redemption amount was restricted to the paid up capital, which was only $.10 per share.

[20] The Class B special shares issued to the Appellant by way of stock dividend had a value of $3 million, equal to their redemption value. As stated earlier in these reasons, the declaration of the stock dividend caused the common shares to decrease in value by an amount equal to the value of the stock dividend. This loss in value was crystallized into a capital loss by the disposition of the common shares to the Family Trust for $100. It is not disputed that the adjusted cost base of the common shares to the Appellant was $3 million, that it received proceeds of disposition of $100 from the sale of the shares, and that the Appellant thereby incurred a capital loss of $2,999,900 according to the provisions of the *Act* read without the GAAR.

Was there an Avoidance Transaction?

[21] The definition of "avoidance transaction" is found in subsection 245(3) of the *Act*:

> 245(3) 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; or
> >
> > (*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.

[22] The parties agree that the series of transactions that gave rise to the tax benefit in this case consisted of the following transactions:

(a) the incorporation of Newco;

(b) subscription for 30,000 common shares of Newco;

(c) Newco declaring a stock dividend of 30,000 Class B special shares, which had a high FMV and low PUC;

(d) the establishment of the Cross Family Trust and the Cross Voting Trust; and

(e) the sale of the Newco common shares to the Cross Family Trust.

[23] Under paragraph 245(3)(*b*) of the *Act*, it is necessary to determine whether the primary purpose of any of these transactions was to obtain the tax benefit. If so, the tax benefit from the series may be denied.[3]

[24] The Respondent argued that while Mr. Cross may have wanted to protect himself from potential creditors, the Appellant had no need for creditor-proofing. The Appellant was not liable on any of the guarantees given by Mr. Cross, and there was no evidence that it has any potential creditors. Therefore the only intent of the plan must have been to generate a capital loss for the Appellant.

[25] Furthermore, counsel suggested that there was evidence that the plan was unsuitable for creditor-proofing Mr. Cross. One of the assumptions made in the legal opinion regarding the plan was that:

> . . . no existing or impending creditors of [the person seeking the creditor protection] would go unpaid as a result of his disposing of the portfolio of investments and that he does not contemplate entering into some activity that carries an appreciable risk of exposing him to unmanageable debts in future.
>
> (Emphasis added)

[26] This was clearly not the case for Mr. Cross because he considered that the guarantees he had given for SSI exposed him to a high risk of significant future liability.

[27] In light of this evidence, the Respondent's counsel submitted that the Appellant had not shown that the purpose of the series of transactions was credit-proofing Mr. Cross rather than creating a capital loss for the Appellant.

[28] The Respondent's counsel also submitted that the Appellant had failed to refute the Minister's assumption in reassessing that each of the transactions within the series was not undertaken primarily for *bona fide* purposes other than to obtain a tax benefit.

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[3] *Ibid* at para 34.

[29] Turning to the specific transactions, Respondent's counsel argued that the primary purpose of at least three of the transactions in the series was to obtain a tax benefit, and therefore, that the tax benefit that existed from the entire series – the capital loss – may be denied under GAAR.

[30] Counsel said that the only purpose for the payment by Newco of a stock dividend on the common shares held by the Appellant and issuing 30,000 Class B non-voting preferred shares to the Appellant was to shift the value of the common shares to the preferred shares (the "value-shift") and thus create a latent capital loss which the Appellant would then realize on the disposition of the common shares to the Trust.

[31] Counsel also said that the only purpose for the creation of the Trust was to allow for the recognition of the capital loss of $2,999,900 on the disposition of the common shares of Newco to it. The disposition of the common shares of Newco to the Trust rather than to Mr. Cross personally, or to a company controlled by Mr. Cross, was undertaken to circumvent the application of the stop-loss rules found in subparagraph 40(2)(*g*)(i), a specific anti-avoidance provision within the *Act.*

[32] Counsel also argued that the creditor-proofing desired by Mr. Cross could have been accomplished under the provisions of the *Act* without the creation of a capital loss by having the Appellant subscribe directly for the Class B special shares, rather than subscribe for common shares and obtain the Class B special shares via a stock dividend. Therefore, the Respondent says that there was no need to cause the value shift between the common and the Class B special shares.

[33] Counsel for the Appellant submitted that it was clear from the uncontradicted testimony of Mr. Cross and Mr. Marshman that the driving force behind the series of transactions was Mr. Cross' need for creditor-proofing. Mr. Cross had good reason to be concerned about potential creditors given his previous history with bankruptcy, the risky venture he was about to begin and his financial situation compared to his new partners in SSI. The evidence showed that Mr. Cross contacted Mr. Marshman for advice regarding creditor-proofing, and that this remained Mr. Cross' goal throughout.

[34] Counsel also submitted that each of the transactions in the series was integral to, and carried out primarily for the purpose of, implementing the creditor-proofing plan. He described the relationship of each transaction to the overall goal of creditor-proofing as follows:

- The incorporation of Newco. The creditor-proofing plan required that the portfolio of assets be held by a corporation with a specific share structure: voting shares, growth shares and credit-proofing shares. Newco was incorporated to be that corporation.

- Subscription for 30,000 common shares of Newco. As mentioned above, the plan required Newco to hold the portfolio of assets. In this transaction, the Appellant transferred the portfolio of assets to Newco and took back common shares of Newco as consideration. The transfer of assets to Newco was a necessary part of the creditor-proofing plan.

- Newco declaring a stock dividend of high FMV-low PUC Class B special shares. Under the plan, the Class B special shares were the creditor-proof shares. The issuance of these shares effectively isolated the value of Newco in the new Class B special shares and allowed this new class of shares (which held all existing value of the portfolio) to be structured so that it would be difficult for a creditor to realize that value.

- The establishment of the Cross Family Trust and the Cross Voting Trust. The Cross Voting Trust was established to hold the voting shares of Newco so that no one person, including any potential creditor who acquired the shares of the Appellant, could control Newco. Keeping control of Newco out of the hands of a creditor was critical because the Class B special shares were valuable only if they were redeemed by Newco. The Cross Family Trust was established to acquire the common shares of Newco. This was essential for two reasons: (i) any future growth in the value of Newco would accrue to the common shares in the hands of the Cross Family Trust and out of the reach of potential creditors; and (ii) the creditor-proofing plan would not work if the Appellant held both the common shares and the Class B special shares – ownership of these classes of shares needed to be separated. Accordingly, the establishment of the trusts was essential to the creditor-proofing objective.

- The sale of the Newco common shares to the Cross Family Trust. For the reasons explained above, the acquisition of the common shares of Newco by the Cross Family Trust was critical to the creditor-proofing plan. The step ensured that the future growth of Newco would accrue to the Cross Family Trust and separated the ownership of the common shares and the Class B

special shares. Without this step, the plan would not have been an effective creditor-proofing plan.

Analysis: Avoidance Transaction

[35] As indicated by the Federal Court of Appeal in *MacKay v. R.*[4], the primary purpose of the series of transactions is always a relevant factor. If the primary purpose of the series is to obtain the tax benefit, the series will be an avoidance transaction. Furthermore, a taxpayer must show that his or her non-tax objective required that each specific step in the series be taken.[5]

[36] In this case, the Respondent says that the only intent of the series of transactions as a whole was to provide the Appellant with an artificial loss. However, in my view, the evidence does not support this conclusion. The uncontradicted testimony of both Mr. Cross and Mr. Marshman was that Mr. Cross approached Mr. Marshman to assist him with creditor-proofing and that the plan that was chosen was selected because it met Mr. Cross' needs in this regard. The reasons given by Mr. Cross for wanting to creditor-proof his assets at that time are also plausible and there is ample evidence to show that he was about to embark upon a new business venture that carried a high degree of risk. Given Mr. Cross' previous bankruptcy and the extent of his potential liability, I accept that he wished to take steps to protect his assets and this motivated him to seek professional advice from Mr. Marshman.

[37] While I agree with counsel for the Respondent that the Appellant itself did not need creditor-proofing, the series of transactions was intended to creditor-proof Mr. Cross, and the creditor-proofing of the Appellant had the effect of creditor-proofing both it and Mr. Cross at the same time.

[38] Finally, to the extent that the legal opinion assumed that there was no contemplation of entering into an activity that carried and appreciable risk of exposing the subject of the creditor-proofing plan to unmanageable debts, this would have been true of the Appellant, because it was not a shareholder in SSI and had not guaranteed its debts.

[39] I turn now to a consideration of the primary purpose for which each transaction in the series was undertaken.

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4 2008 FCA 105, [2008] 4 CTC 161 at para 25.

5 *Ibid* at para 22.

[40] In my view, the Appellant has not shown that the issuance of the common shares to the Appellant was done primarily for the non-tax creditor-proofing purpose. It appears that this step in the series did not accomplish anything that was integral to the creditor-proofing. The protection of the Appellant's assets was achieved through the issuance of the Class B special shares to the Appellant, but it has not been shown that it was necessary for the Appellant to first subscribe for common shares and then receive the Class B shares by means of a stock dividend that was paid on the common shares.

[41] The Appellant's counsel submitted that the Appellant had to subscribe for the common shares because it was necessary for the Appellant to transfer its assets to Newco, the common shares being what it received back in exchange. However, I see no reason why the Appellant could not have received shares with the same restrictions on redemption value as the Class B special shares in exchange for the assets it transferred to Newco. If the shares that the Appellant took back from Newco in exchange for the transfer of the Appellant's assets carried the same restrictions on redemption value as the Class B special shares, this would have achieved the creditor-proofing purpose sought by the Appellant.

[42] Similarly, while it was necessary for the Family Trust to have common shares in Newco, there does not appear to be any reason why the shares could not have been issued to the Family Trust directly.

[43] The only reason I can see that the Appellant acquired the common shares was to permit the value of those shares to be shifted to the Class B shares prior to their disposition to the Family Trust. This purpose had nothing to do with creditor-proofing and was designed to generate a capital loss for the Appellant.

[44] Mr. Marshman was asked by counsel for the Appellant about the purpose of the common shares in the plan. His answer was that the common shares allowed the future growth in Newco to go to the Family Trust. As I have said already, this purpose could just as easily have been achieved by having the Trust acquire the common shares directly.

[45] Mr. Marshman also said that none of the transactions in the series could have been skipped because "we were trying to tailor this to meet the legal opinion we had on creditor-proofing." That legal opinion consisted of an opinion on a hypothetical series of transactions for all intents and purposes identical to those undertaken in this case. The opinion letter states that the law firm was asked "to comment on certain corporate law and debtor law aspects of the proposed financial

structure described herein and the steps necessary to achieve that structure." The opinion letter, however, does not analyze the purpose of each of those proposed steps, or state that each of those steps is necessary to achieve the creditor-proofing objective. The opinion letter simply states, in the last paragraph, that:

> From a corporate law perspective, we have considered whether there are alternative approaches to the structure that would accomplish the desired objectives in a more effective manner. The alternative approaches that we have considered are no more advantageous than this structure in meeting the [client's] objectives.

[46] In my view, the legal opinion offers no support for the proposition that all of the transactions in the series were necessary to accomplish the creditor-proofing objective. All that can be said is that none of the undisclosed alternatives that were considered would have been more effective in their result or more advantageous to the client.

[47] Although it is not necessary for me to consider the purpose of the remaining transactions in the series, I agree with the Appellant, for the reasons given by its counsel, that they were necessary to achieve the creditor-proofing objective.

Was there abusive tax avoidance?

[48] I turn now to subsection 245(4) of the *Act* and the determination of whether there has been abusive tax avoidance in this case. Subsection 245(4) reads as follows:

> 245(4) Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction
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> (*a*) would, if this *Act* were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of
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> (i) this *Act*,
>
> (ii) the *Income Tax Regulations*,
>
> (iii) the *Income Tax Application Rules*,
>
> (iv) a tax treaty, or
>
> (v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or
>
> (*b*) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.

[49] In the *Canada Trustco* case, the Supreme Court of Canada set out the approach to be followed in making this determination.[6] At paragraphs 44 and 45 of that decision, the Court said:

> 44 The heart of the analysis under s. 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case. The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The next task is to determine whether the transaction falls within or frustrates that purpose. The overall inquiry thus involves a mixed question of fact and law. The textual, contextual and purposive interpretation of specific provisions of the *Income Tax Act* is essentially a

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6 Above, note 1.

> question of law but the application of these provisions to the facts of a case is necessarily fact-intensive.
>
> 45 This analysis will lead to a finding of abusive tax avoidance when a taxpayer relies on specific provisions of the *Income Tax Act* in order to achieve an outcome that those provisions seek to prevent. As well, abusive tax avoidance will occur when a transaction defeats the underlying rationale of the provisions that are relied upon. An abuse may also result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions. By contrast, abuse is not established where it is reasonable to conclude that an avoidance transaction under s. 245(3) was within the object, spirit or purpose of the provisions that confer the tax benefit.

[50] The Respondent has the burden of establishing abusive tax avoidance.[7]

[51] The Respondent maintains that the underlying rationale of the provisions of the *Act* that deal with the computation and deduction of capital losses is to allow a deduction where a taxpayer has suffered a real economic loss on a disposition of property. The *Act* further limits the deduction of losses to situations where the property has been disposed of to a person outside the economic unit of which the taxpayer forms a part**.** It is therefore maintained that the result of the series of transactions undertaken by the Appellant defeats this policy of the *Act*.

[52] Counsel said that a consideration of the legislative history of the capital regime reveals that from the outset and up to the time of the transactions in issue, the deduction of capital losses under the *Act* has been limited by anti-avoidance rules that deny the recognition of artificial, superficial or undue losses. The specific capital loss anti-avoidance provisions referred to above were enacted concurrently with the adoption of the new capital gains regime under the 1972 *Income Tax Act*, and this showed that Parliament consistently intended to deny the recognition of artificial, superficial or undue losses and losses that do not result from a true disposition of property.

[53] Former subsection 55(1) provided that any undue reduction of the amount of a capital gain or the undue creation of, or increase in the amount of, a capital loss on the disposition of property would be disregarded in determining the taxpayer's gain or loss and the disposition.

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7 *Ibid* at para 66.

[54] While subsection 55(1) was repealed in 1988, counsel submitted that the Technical Notes accompanying its repeal clearly indicate that Parliament still intended that only real capital losses should be deductible, and that the losses previously covered by former subsection 55(1) would be denied under the GAAR. The Technical Notes read as follows:

> Subsection 55(1) of the Act is an anti-avoidance provision aimed at transactions designed to artificially or unduly reduce a capital gain or increase or create a capital loss on a disposition of property.
>
> Subsection 55(1) is repealed as a consequence of the introduction of new section 245 of the Act, which constitutes a general anti-avoidance rule. Because the scope of that general anti-avoidance rule is broad enough to cover the transactions to which subsection 55(1) was intended to apply, that subsection is no longer necessary.

[55] Similarly, counsel said that subparagraph 40(2)(*g*)(i) in conjunction with the definition of "superficial loss" in paragraph 54(*g*) showed that Parliament intended that only losses resulting from a true disposition of property would be deductible.

[56] Counsel for the Respondent argued that the transactions undertaken by the Appellant defeated or frustrated the underlying rationale of paragraph 38(*b*), the provision relied upon by the Appellant because those transactions did not result in a true economic loss. The loss was fabricated by manipulating the fiscal "amount or value" of the Newco shares held by the Appellant for only 24 hours, and ultimately the Appellant did not suffer any loss. Counsel said that the economic substance of the transactions was a relevant consideration to the extent that they established that the transactions frustrate the purpose of the relevant statutory provisions.[8]

[57] Counsel also argued that the transactions circumvented the stop-loss rule in subparagraph 40(2)(*g*)(i), which deems a loss from dispositions of capital property to an affiliated person to be nil. It is the Respondent's position that the transactions achieve an outcome that this stop-loss rule seeks to prevent: the creation of a loss between parties with the same economic affiliations.

[58] Counsel for the Respondent asserted that the Cross Family Trust was used to acquire the Newco common shares in order to avoid the application of subparagraph 40(2)(*g*)(i). In 2003, when these transactions were carried out, trusts

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[8] *Lipson v R.*, 2009 SCC 1, [2009] 1 S.C.R. 3 at para 38.

and beneficiaries of trusts were not included in the definition of “affiliated persons” in section 251.1.

[59] Counsel also submitted that the amendment in 2005 to the definition of “affiliated persons” in section 251.1 to include trusts and majority-interest beneficiaries was aimed at disallowing losses such as those in this case. If the amended definition had been in effect in the 2003 taxation year, the loss on the disposition of the common shares to the Cross Family Trust would have been deemed to be nil. Counsel argued that by closing the loophole in the stop-loss rules relied upon by the Appellant, Parliament was demonstrating that the loss obtained by the Appellant was unintended.

[60] The Appellant counsel asserted that the Respondent has not met the burden of demonstrating abusive tax avoidance. The provision relied upon by the Appellant to calculate its capital loss and allowable capital loss operate in a mechanical fashion and provide that a loss will result where there has been a decrease in value of a capital asset. Since it is conceded that the adjusted cost base of the Newco common shares to the Appellant was $3 million, and the proceeds of disposition received for those shares was $100, a capital loss of $2,999,900 resulted, all in accordance with the underlying rationale of the sections that were used.

[61] The Appellant also maintains that the Respondent has not identified any specific provisions of the *Act* that demonstrate a general policy of denying artificial losses. Counsel relied upon paragraphs 41 and 42 of the Supreme Court of Canada decision in *Canada Trustco* where the Court said:

> 41 The courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions in issue. First, such a search is incompatible with the roles of reviewing judges. The *Income Tax Act* is a compendium of highly detailed and often complex provisions. To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. Did Parliament intend judges to formulate taxation policies that are not grounded in the provisions of the Act and to apply them to override the specific provisions of the Act? Notwithstanding the interpretative challenges that the GAAR presents, we cannot find a basis for concluding that such a marked departure from judicial and interpretative norms was Parliament's intent.

> 42 Second, to search for an overriding policy of the *Income Tax Act* that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit would run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs. Although Parliament's general purpose in enacting the GAAR was to preserve legitimate tax minimization schemes while prohibiting abusive tax avoidance, Parliament must also be taken to seek consistency, predictability and fairness in tax law. These three latter purposes would be frustrated if the Minister and/or the courts overrode the provisions of the *Income Tax Act* without any basis in a textual, contextual and purposive interpretation of those provisions.[9]

[62] Counsel submitted that the Respondent is seeking to apply GAAR based on what its view of the law ought to be, rather than on the basis of policy as expressed in the words of the *Act*. This approach, he said, has the effect of turning the GAAR into a smell test and defeats the requirement for certainty, fairness and predictability in tax law.

Textual Contextual and Purposive Analysis

[63] The provisions that give rise to the capital loss in issue form part of the capital gains tax regime introduced in the 1972 *Act*. Capital gains and losses and taxable capital gains and allowable capital losses are calculated in accordance with the rules found in Subdivision c of Division B of Part I of the *Act*.

[64] Paragraph 39(1)(*b*) provides that a taxpayer's capital loss from the disposition of any property is his or her loss calculated according to the rules in Subdivision c, and paragraph 38(*b*) determines the portion of the capital loss, referred to as an "allowable capital loss" that is relevant in computing a taxpayer's income under section 3 as an offset to capital gains made by the taxpayer:

> 38**.** For the purposes of this Act,
>
> …
>
> (*b*) a taxpayer's allowable capital loss for a taxation year from the disposition of any property is 1/2 of the taxpayer's capital loss for the year from the disposition of that property;
>
> 39. (1) For the purposes of this Act,

---

[9] Above, note 1.

…

> (*b*) a taxpayer's capital loss for a taxation year from the disposition of any property is the taxpayer's loss for the year determined under this subdivision . . . from the disposition of any property of the taxpayer other than
>
> > (i) depreciable property, or
> >
> > (ii) property described in any of subparagraphs 39(1)(*a*)(i), (ii) to (iii) and (v);

[65] The general rules for calculating a loss from the disposition of property are found in subparagraph 40(1)(*b*)(i) which reads:

> 40. (1) Except as otherwise expressly provided in this Part
>
> …
>
> (b) a taxpayer's loss for a taxation year from the disposition of any property is,
>
> > (i) if the property was disposed of in the year, the amount, if any, by which the total of the adjusted cost base to the taxpayer of the property immediately before the disposition and any outlays and expenses to the extent that they were made or incurred by the taxpayer for the purpose of making the disposition, exceeds the taxpayer's proceeds of disposition of the property, . . .

[66] In the case of property other than depreciable capital property, "adjusted cost base" is defined in paragraph 54(*a*) of the *Act* as the cost of the property to the taxpayer adjusted in accordance with section 53. The starting point for that determination is the taxpayer's cost of the property. The relevant portion of the definition of "adjusted cost base" reads as follows:

> "adjusted cost base" to a taxpayer of any property at any time means, except as otherwise provided,
>
> > (a) where the property is depreciable property of the taxpayer, the capital cost to the taxpayer of the property as of that time, and
> >
> > (b) in any other case, the cost to the taxpayer of the property adjusted, as of that time, in accordance with section 53,

[67] "Disposition" is defined in subsection 248(1) to include "any transaction or event entitling a taxpayer to proceeds of disposition of property". Finally,

“proceeds of disposition” is defined in section 54 to include “the sale price of property that has been sold”.

[68] Through the various provisions set out above, it can be seen that, generally speaking, a capital loss is allowed where a taxpayer has disposed of property and received proceeds from the disposition that are less than the taxpayer’s cost of the property plus outlays and expenses incurred for the purpose of the disposition.

[69] As noted by the Respondent, subparagraph 40(2)(*g*)(i) denies a loss to the extent that it is a “superficial loss”. A “superficial loss” is defined in section 54 as a loss occurring on a disposition of property by a taxpayer and a reacquisition of the same or an identical property by a taxpayer within 30 days before or after the disposition, or an acquisition of the same property or an identical property by a person affiliated with the taxpayer within 30 days before or after the disposition.

[70] The parties agree that the Appellant and the Cross Family Trust were not “affiliated persons” as that term was defined in section 251.1 of the *Act* for the year in issue.

[71] In 2005 the definition of “affiliated persons” was amended to include a trust and majority-interest beneficiaries of the trust. A “majority-interest beneficiary” is defined in subsection 251.1(3) as a beneficiary of a trust who, either alone or together with certain other affiliated persons, is entitled to more than half of the trust’s income or capital. Pursuant to paragraph 251.1(4)(*d*), in determining whether a person is affiliated with a trust, if the amount of income or capital the person is entitled to receive from the trust depends on the exercise of a discretionary power by any person, that person will be deemed to have exercised the discretionary power. These provisions read as follows:

> 251.1(3) "majority-interest beneficiary", of a trust at any time, means a person whose interest as a beneficiary, if any, at that time
>
> > (a) in the income of the trust has, together with the interests as a beneficiary in the income of the trust of all persons with whom the person is affiliated, a fair market value that is greater than 50% of the fair market value of all the interests as a beneficiary in the income of the trust; or
> >
> > (b) in the capital of the trust has, together with the interests as a beneficiary in the capital of the trust of all persons with whom the person is affiliated, a fair market value that is greater than 50% of the fair market value of all the interests as a beneficiary in the capital of the trust.
>
> 251.4 (4) Interpretation

. . .

(d) in determining whether a person is affiliated with a trust,

(i) if the amount of income or capital of the trust that a person may receive as a beneficiary under the trust depends on the exercise by any person of, or the failure by any person to exercise, a discretionary power, that person is deemed to have fully exercised, or to have failed to exercise, the power, as the case may be,

(ii) the interest of a person in a trust as a beneficiary is disregarded in determining whether the person deals at arm's length with the trust if the person would, in the absence of the interest as a beneficiary, be considered to deal at arm's length with the trust,

(iii) a trust is not a majority interest beneficiary of another trust unless the trust has an interest as a beneficiary in the income or capital, as the case may be, of the other trust, and

(iv) in determining whether a contributor to one trust is affiliated with a contributor to another trust, individuals connected by blood, marriage, common-law partnership or adoption are deemed to be affiliated with one another.

[72] In the case of the Cross Family Trust, Mr. Cross' spouse and his two children were entitled to payments of income and capital at the complete discretion of the trustees. Had paragraph 251.1(4)(*d*) been in effect at the relevant time, I find that Mr. Cross' spouse would have been a majority-interest beneficiary on the basis of the trustees' discretion to pay her up to 100% of the income and capital of the trust.

[73] I will deal firstly with the Respondent's argument that the *Act* contains a general policy against allowing losses on dispositions of property to persons with the same economic affiliations as the transferor. The Respondent's counsel also referred to this as the transferee being part of the same economic unit as the transferor.

[74] This argument is very similar to the one that the Respondent made before me in *Landrus v The Queen*.[10] There, the taxpayer was a member of a limited partnership that had transferred all its assets to a new limited partnership. The transfer resulted in a terminal loss to the original partnership. The taxpayer's claim for his share of the terminal loss was denied by the Minister under section 245 of

[10] 2008 TCC 274, [2009] 1 CTC 2009.

the *Act*. The Crown argued in that case that the loss contravened the general policy in the *Act* to disregard losses on dispositions of property to parties related to the transferor. In support of its position, the Crown cited various stop-loss rules, including paragraph 40(2)(*e*) and subparagraph 40(2)(*g*)(i). However, I concluded that the stop-loss rules referred to did not evidence the general policy contended by the Crown, but were intended to deny losses in the limited and specific circumstances set out in those provisions. At paragraph 117 of my decision, I wrote:

> . . . These rules are precisely drafted and set out detailed conditions for the denial of a loss that would otherwise arise on the disposition of a particular type of property. Those conditions vary from one stop-loss rule to the other. An important variation, for the purposes of this case, is in the degree of connection or relationship required between the transferor and transferee.

[75] This finding was upheld by the Federal Court of Appeal, which wrote, at paragraph 47 of its decision:

> . . .However, where it can be shown that an anti-avoidance provision has been carefully crafted to include some situations and exclude others, it is reasonable to infer that Parliament chose to limit their scope accordingly.[11]

[76] The definition of "affiliated persons" in section 251.1 as it read for the year in issue sets out a carefully crafted group of relationships, and I believe that it is reasonable to infer that Parliament chose to limit the scope of the definition accordingly.

[77] In *Landrus*, I also considered the effect of the amendments to the stop-loss rules subsequent to the taxation year in which the loss in that case was claimed. Those amendments would have disallowed the loss claimed by the taxpayer. This is similar to what happened in this case, as a result of the amendment to the definition of "affiliated persons" to include trusts and majority-interest beneficiaries. If those amendments had been in effect in the year in issue, the appellant and the Cross Family Trust would have been affiliated because Mr. Cross' spouse would have been a majority-interest beneficiary of the Trust on the basis of the trustees' discretion to pay her up to 100% of the income and capital of the trust. (see paragraph 251.1(4)(*d*))

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[11] *Landrus v. R.*, 2009 FCA 113, [2009] 4 CTC 189.

[78] I held, though, that the amendments in *Landrus* did not "alter the fact that the stop-loss rules were exceptions that operate in well-defined circumstances" and that even after the amendments they did not deny losses on all transfers between all related parties. Therefore, the amendments were not material to the determination of the policy underlying the stop-loss rules in effect for the year under appeal.

[79] The Respondent has not shown that there is readily apparent commonality between the relationship of trust and majority-interest beneficiary and the other relationships specified in the pre-amendment definition of "affiliated persons" such that one can say that Parliament intended the definition to cover that type of relationship as well.

[80] The difficulty for the Respondent is that the related parties that Parliament treats as being part of the same economic unit varies from one stop-loss rule to the next. There is not one overall definition of an economic unit that is applicable for all of the stop-loss rules. Therefore, it cannot be said that there was a clear and unambiguous policy in the *Act* to treat parties such as the Appellant and the Cross Family Trust as part of the same "economic unit" for the purposes of subparagraph 40(2)(*g*)(i).

[81] I find that the Respondent in this case has not shown that there is a general policy in the *Act* to disallow losses on any transfer of property to persons with the same degree of connection as the Appellant and the Cross Family Trust. Therefore I find that the triggering of the loss by transferring the common shares to the Cross Family Trust is, in and of itself, not abusive tax avoidance.

[82] I am aware that in *Triad Gestco Ltd v The Queen*,[12] my colleague, Favreau J, recently held that even prior to the amendment of the definition of "affiliated persons" in section 251.1, there was a general policy in the *Act* to deny losses on transfers of property between a person and a trust where the person was the sole beneficiary of the trust:

> 96 Subsection 251.1(1) now ensures that transactions between a trust and a person with whom it is "affiliated" will be subject to the stop-loss rules contained in the *Act*.
>
> 97 In my opinion, the 2005 amendment to section 251.1 is a clear indication that the results achieved by the appellant were contrary to the object, spirit and purpose of the *Act* when read as a whole.

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[12] 2011 TCC 259, [2011] T.C.J. No. 268 at paras 96 and 97.

[83] For the reasons set out above, I must respectfully disagree with this conclusion.

[84] I will now address the Respondent's argument that the transactions defeated or frustrated the underlying rationale of paragraph 38(*b*) because they did not result in a true economic loss to the Appellant.

[85] I agree with the Respondent that the purpose of paragraph 38(*b*) is to give tax relief (to the extent of an offset against capital gains) in circumstances where a taxpayer has suffered an economic loss on the disposition of property. This is apparent from the manner in which a loss is calculated, by determining the excess of the cost of the property over the proceeds from the disposition of the property. Furthermore, capital gains are recognized as income under the *Act* because they represent an addition to a taxpayer's economic power. *The Report of the Royal Commission on Taxation*,[13] proposed that capital gains be taxed for the following reasons:

> Rights to and interests in property can produce increases in economic power, whether held or disposed of. These increases take two basic forms: rents, dividends, royalties,interest, and other returns derived from holdng property rights; and gains derived from increases in the market value of property rights. The first form is already taxed as income in Canada, while the second is normally exempt as a "capital gain". While the changes we propose in the taxation of returns from holding property are minor, we suggest a major change in the tax treatment of gains on the disposal of property. We have emphasized in this Report that the only equitable basis for taxation is to include in the comprehensive tax base the value of all additions to economic power, including so-called capital gains.

[86] It is logical to infer that capital losses are allowed under the *Act* as an offset to capital gains because they represent a decrease to a taxpayer's economic power.

[87] In addition, the Explanatory Notes to section 245 state that the provisions of the *Income Tax Act* are intended to apply to transactions with real economic substance. the Supreme Court of Canada discusses this point at paragraph 56 of the *Canada Trustco* decision:

> 56 The Explanatory Notes elaborate that the provisions of the *Income Tax Act* are intended to apply to transactions with real economic substance. Although the

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[13] Kenneth LeM. Carter, 1966.

> expression "economic substance" may be open to different interpretations, this statement recognizes that the provisions of the Act were intended to apply to transactions that were executed within the object, spirit and purpose of the provisions that are relied upon for the tax benefit. The courts should not turn a blind eye to the underlying facts of a case, and become fixated on compliance with the literal meaning of the wording of the provisions of the Income Tax Act. Rather, the courts should in all cases interpret the provisions in their proper context in light of the purposes they intend to promote.[14]

[88] I also agree with counsel for the Respondent that former subsection 55(1) of the *Act* is relevant in determining the policy of the *Act* concerning capital losses and forms part of the context for the interpretation of the capital loss provisions of the *Act*. While subsection 55(1) has been repealed, the reason for the repeal was not because of a change of policy, but because Parliament believed the policy behind the repealed provision could be enforced by means of the then newly introduced section 245. The Technical Note that accompanied the repeal of subsection 55(1) is clear in this respect. Technical Notes and Explanatory Notes are permissible extrinsic aids in the determination of legislative policy in a GAAR case: see *The Queen v. Imperial Oil Inc.*[15]

[89] The former subsection 55(1) was a tax avoidance provision aimed at the artificial reduction of gains and the artificial creation or increase in the amount of losses on the disposition of property. Since subsection 55(1) operated for the purposes of subdivision c of the *Act*, its application was limited to capital gains and losses.

[90] I find that the Respondent has shown that the purpose of paragraph 38(*b*) is to recognize economic losses suffered by a taxpayer on the disposition of property. The Respondent has also shown that despite the repeal of subsection 55(1), the policy of the *Act* is still to disallow the artificial or undue creation or increase of a capital loss, which underlines the intention to allow capital losses only to the extent that they reflect an underlying economic loss.

[91] The next step in the analysis under subsection 245(4) is to examine the transactions undertaken by the Appellant to determine whether they defeat or frustrate the object, purpose or spirit of paragraph 38(*b*) of the *Act*.

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[14] Above, note 1.

[15] 2004 FCA 36, 2004, DTC 6044 F.C.A. at para 49.

[92] In this case, the Appellant acquired the common shares of Newco and disposed of them almost immediately thereafter while retaining the full value of its interest in Newco by means of the Class B special shares. From the way in which the transactions were structured, it is clear that there was never any intention that the common shares would represent the true value of the Appellant's interest in Newco, but rather, the Appellant would have access to the full amount of his investment in Newco through the Class B special shares. The acquisition of the common shares by the Appellant and the pre-ordained disposition of the common shares to the Trust served no purpose other than to manufacture a capital loss for tax purposes. These transactions did not reduce the Appellant's economic power in the manner contemplated by Parliament in allowing for the deduction of capital losses. The transactions are artificial and lack substance with respect to paragraph 38(*b*) as well as other capital loss provisions of the *Act*, specifically, paragraphs 39(1)(*b*) and 40(1)(*b*) which are premised on actual economic losses being incurred.

[93] In summary, I find that the transactions carried out in this case were not executed within the object spirit and purpose of the capital loss provisions of the *Act* and that they constitute abusive tax avoidance under subsection 245(4).

[94] For all these reasons, the appeal is dismissed, with costs.

Signed at Ottawa, Canada, this 7th day of September 2011.

"B.Paris"

Paris J.

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