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by Steve Suarez

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HIGHLIGHTS

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Canadian Court Pulls Plug on GAAR Appeal

by Steve Suarez

Over the past few years, three cases dealing with the alleged manufacturing of losses have worked their way through the Canadian tax courts. These cases essentially dealt with transactions in which steps were taken to shift value from one class of shares of a corporation that had a relatively high cost basis for tax purposes into a different class of shares.[1] The first class of shares was then disposed of and a loss was claimed. In each case, the Canada Revenue Agency denied recognition of the loss on the basis that no true economic loss had occurred and that the general antiavoidance rule in the Income Tax Act (Canada) applied to deny recognition of the loss.

In two of the three cases (prior coverage: *Tax Notes Int'l*, Oct. 29, 2012, p. 446), the taxpayer lost both in the Tax Court of Canada and again on appeal in the Federal Court of Appeal (FCA). The third case (*Global Equity Fund Ltd. v. Her Majesty the Queen* (2012 FCA 272)) was interesting, because the taxpayer succeeded at the Tax Court level despite that court's finding (in paragraph 4) that the transactions were ''highly artificial'' and that the loss resulted ''from a shuffle of paper'' by which ''no real economic loss was suffered.'' (Tax Court ruling (2011 TCC 507).)

The Tax Court judge concluded that despite those facts, the Crown failed to establish that any specific provisions of the ITA, or the ITA as a whole, had been the subject of an abuse or misuse. The court (in paragraphs 90-92) said:

> It is important to note that the Crown does not allege that any of the provisions relied on for the tax benefit (s. 3, 4, 9, 111) have been misused. Section 9 appears to be a key provision relied on by Global as it brings in commercial principles in calculating income and loss. The Crown acknowledges that this provision, read alone, permits the deduction of the loss claimed by Global.
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> The essence of the Crown's argument is that the object and spirit of the provisions relied upon by Global are influenced by other provisions in the Act. These provisions all restrict the deduction of losses in one way or another. It is submitted that, as a result of these other provisions, the object and spirit of the provisions relied on is disclosed. As a result, only real losses realized outside the economic unit may be deducted.
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> The problem that I have with the Crown's argument is that the provisions referred to by the Crown are limited in scope. None of them, either separately or together, in my view, are suggestive of the broad object and spirit that business losses are limited to real losses realized outside the economic unit.

On appeal by the Crown, the FCA reversed the finding of the Tax Court and ruled that the GAAR should indeed be applied to deny recognition of the loss. The FCA held that properly interpreted, the basic provisions of the ITA relevant to the computation of income and losses require that in order for a loss to be recognized for tax purposes, ''there must, at the very least, be an air of economic or business reality associated with that loss'' (paragraph 63). (FCAruling.) This standard was not met, in the FCA's opinion, and in paragraphs 66-68, it said the GAAR should be applied to deny recognition of the loss:

> The loss generated by Global as a result of the transactions resulted from a value shift between one of the classes of shares held by Global to another class of shares it held. This is simply a paper loss. The fundamentals of the transactions are simple: the inherent value of the common shares in Newco held by Global was moved to the preferred shares issued to Global, with the result that the common shares were left with little value but still with a high cost associated to them, while the preferred shares issued as a dividend had a high value but a low associated cost. Nothing was gained or lost, however in selling the common shares to the Children's Trust, Global technically realized a large loss on paper.

[1]Essentially, the taxpayer subscribed for common shares in the issuing corporation (Newco), which then issued preferred shares with a high redemption value and nominal paid-up capital to the taxpayer by way of a stock dividend. By virtue of their preferred claim on the assets of Newco, the preferred shares represented essentially all of the value of Newco's equity, leaving virtually no value in the common shares.

> The vacuity and artificiality of transactions may confirm their abusive nature: *Mathew v. Canada*, 2005 SCC 55, [2005] 2 S.C.R. 643 (sub. nom. *Kaulius v. The Queen*) at para. 62. The Tax Court judge found that the transactions at issue in this case were ''vacuous'' and ''highly artificial''. I agree. Like the proverbial rabbit out of the magician's hat, the loss which occurred as a result of these transactions was pulled out of thin air. These transactions are nothing more than a paper shuffle carried out with the purpose of creating an artificial business loss for the purpose of avoiding the payment of taxes otherwise owed on the profits resulting from the real-world business operations of Global.
>
> There is no air of economic or business reality associated with the loss, and consequently, I find that the transactions which created this artificial loss defeat the underlying rationale of sections 3, 4, 9 and 111 of the Act, to the extent that these provisions allow for the use of business losses for income taxation purposes.

The taxpayer appealed to the Supreme Court of Canada, which on April 11 declined to hear the appeal. As a result, the decision of the FCA is now final. ◆

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