

Welcome to the third UBC Tax newsletter. This issue of UBC Tax provides a short article by one of UBC's recently graduated tax LL.M. students on recent general anti-avoidance cases, highlights the work of UBC students in directed studies with a tax focus, congratulates the students who won tax prizes in the 2005/2006 academic year, and invites your firm to participate in our tax information and networking event.

The GAAR Since *Canada Trustco*—Still In Search of Clarity

Nearly a year after the Supreme Court of Canada issued its widely-anticipated first GAAR decisions, the distinction between legitimate tax planning and abusive tax avoidance remains as muddled as ever. The Tax Court continues to struggle to develop a consistent approach to dealing with innovative transactions designed either to outright avoid, or to defer, tax through the use of promissory notes, partnerships and rollovers. Indeed, recent cases illustrate a continuing confusion regarding how the courts should determine whether a transaction results in a misuse of provisions of the Act or in an abuse of the Act as a whole.

For instance, in *Evans v. The Queen*, 2005 TCC 684, the taxpayer restructured his shareholdings for the purpose of extracting corporate surplus tax-free on a going-forward basis. The taxpayer sold shares of his company on a tax-exempt basis to a new partnership formed by low-rate family members in exchange for a promissory note. When the company subsequently distributed its surplus as dividends and through share redemptions, that income was first received by the low-rate partners—who collectively paid virtually no income tax at all—and then flowed to the taxpayer tax-free as repayments on the note (except for interest on the note, which was taxable). The transaction was not a classic surplus strip because the taxpayer was not winding up the company. Rather, the transaction enabled him to extract corporate surplus on an ongoing basis and to escape the tax that would have been payable had he received the dividends directly.

One might be forgiven for believing that, after the decisions in *McNichol v. The Queen*, 97 DTC 111 (TCC) and *R.M.M. Canadian Enterprises Inc. v. The Queen*, 97 DTC 302 (TCC), it was settled that surplus stripping, which involves the extraction of corporate surplus through a tax-exempt sale of shares rather than through taxable dividends, is generally considered abusive tax avoidance in Canadian tax law. In *McNichol*, the Tax Court had identified a general legislative scheme designed to tax distributions of corporate surplus as income regardless of the legal form in which it is received. Chief Justice Bowman disagreed, however. He concluded not only that the *Evans* transaction was not abusive, but also that it was not even an avoidance transaction because the extraction of corporate surplus in the most tax-efficient manner possible is itself a bona fide non-tax purpose. He rejected the *McNichol* finding that the scheme of the Act intends to tax corporate surplus as dividends, and even suggested that the outcome in *McNichol* might have been different had it been decided after *Canada Trustco*.

In deciding as he did, Chief Justice Bowman was influenced by the fact that each section of the Act relied upon by the taxpayer worked as it was supposed to when the legal forms of the transactions were given effect. He also concluded that the fact that the taxpayer's company continued its operations, and actually declared dividends, sufficiently distinguished *Evans* from *McNichol*. With respect, however, one could argue that the *Evans* transaction is even more abusive than a classic surplus strip because the *Evans* "strip" operated on an ongoing basis rather than in the limited context of a winding up. If the *Income Tax Act* envisages that distributions of corporate surplus should be taxed as dividends, then one would expect the distribution of corporate surplus on an ongoing basis—which is typically effected through periodic dividends—to be even more clearly intended to be treated as dividend income than the distribution of surplus on a final winding-up or liquidation of the company. Furthermore, the transaction resulted in the dividends first being taxed to low-rate taxpayers before cycling back to the original shareholder mainly tax-free. The partnership therefore appears to have functioned as a mere conduit for the dividends.

In *Ceco Operations Ltd. v. The Queen*, 2006 TCC 256, the taxpayer used a partnership to defer tax on a portion of the sale of business assets that was extracted and paid up to the ultimate owners. In *Ceco*, a parent corporation selling business assets for \$35 million rolled them into a new subsidiary (the taxpayer *Ceco*) under s. 85(1), which then rolled them into a new partnership formed with the prospective purchaser. The partnership rollover under s. 97(2) was done at an elected amount of \$17 million, and the \$35 million consideration was structured as \$16.8 million of "boot" and a partnership unit valued at \$18.6 million. Using funds contributed by the purchaser, the partnership then acquired \$18.7 million of preferred shares in *Ceco*'s newly-incorporated sister corporation, which in turn acquired \$18.7 million of preferred shares in holding companies through which six employees of the parent ultimately owned *Ceco*'s business.

Justice Bonner concluded both that there was no bona fide non-tax purpose for the partnership rollover and the acquisitions of preferred shares, and that the transaction resulted in an abuse of s. 97(2). He observed that the purpose of the rollover is to permit a tax deferral when a taxpayer has not extracted the economic value of their assets but is merely holding them in a different form. Therefore, the Act makes a rollover available only if the value of boot received is less than the elected amount—the remainder of the consideration is received in the form of a partnership interest. In *Ceco*, he concluded that

although the boot of \$16.8 million was less than the elected amount of \$17 million, "in the real world" the partnership unit received as consideration for Ceco's assets represented nothing more than an undertaking to pay \$18.7 million for preferred shares of the owners' Holdcos. As a result, permitting Ceco to benefit from the rollover would allow the owners to extract \$18.7 million of the value of the assets without that amount being taxed when the assets were disposed of by Ceco and would abuse s. 97(2).

Evans and *Ceco Operations* both considered transactions designed to realize economic value in a tax-efficient manner by first flowing it through a different entity for the purpose of reducing or avoiding the tax payable by the ultimate recipient when they would not have enjoyed the tax benefit had they extracted that economic value directly. These cases indicate the importance of looking to the commercial reality of transactions, and of considering whether the outcome that results if their legal forms are respected is abusive of the Act. In *Evans*, the Court appears not to have done so but to have accepted that the fact that the transactions legally "worked" is indicative that there is no abuse. In *Ceco Operations*, by contrast, Justice Bonner concluded that, in the circumstances, treating the partnership unit as such and permitting the

rollover accordingly would result in a "patent abuse" by allowing the tax-deferred proceeds to flow up to the ultimate owners' holdcos.

In *Canada Trustco Mortgage Company Ltd. v. Canada*, 2005 DTC 5523, the Supreme Court of Canada characterized the determination of a transaction's purpose and of whether the transaction frustrates the purpose of the legislation as questions of fact best suited to Tax Court Judges to decide. Those comments were widely interpreted as a signal to the tax bar and the lower courts that the Court did not wish to see GAAR cases continue to be appealed. Several GAAR cases decided since then have already been appealed, however, including *Ceco Operations* itself (although not *Evans*). Therefore, it is likely that the Federal Court of Appeal, if not the Supreme Court of Canada, will pronounce upon the GAAR again relatively soon. Given the evident confusion that persists in this area, the tax bar, the tax authorities, and the Tax Court itself would surely welcome some further clarification.

Michael Taylor practices tax litigation with the Department of Justice and completed an LL.M. in tax at UBC Law in 2006. The views expressed are his own and do not state the position of the Department of Justice or the CRA.

Directed Studies in Tax

Students at UBC Law are encouraged to develop their analytical, research, and writing skills by pursuing directed studies with UBC Law faculty. Every year, several students choose to conduct research in advanced areas of taxation. Summaries of some of this year's directed studies papers are provided below.

"INCOME TRUST MECHANICS: TAXATION AND POLICY"

Mark Barbour

This paper discusses the tax efficiency of income trust structures. It traces the taxation of income earned by an operating entity as that income passes through the structure and into the hands of investors. The paper concludes by briefly considering potential policy approaches available to the Department of Finance in response to the recent proliferation of income trusts in Canada.

"DOUBLE DIPS AND ULCS: INTERNATIONAL TAX PLANNING STRATEGIES"

Mark Barbour

This paper examines the taxation rules applicable to two international tax planning strategies. The first part of the paper focuses on double dip financing structures that allow corporate families to multiply interest deductions across jurisdictions. The second part of the paper looks at how Canadian unlimited liability corporations can be used by US investors expanding into Canada.

"TAXING THE INCOME TRUST STRUCTURE"

Morgan Hay

This paper first examines the income trust structure and various negative consequences for the tax system given how that structure is currently taxed. It then discusses the November 2005 government proposal to alter the taxation of income trusts, and outlines the criticisms of that proposal. Finally, the paper concludes by setting out a mechanism for judging possible alternative schemes for taxing income trusts, and evaluates several possible options.

"TAX INCENTIVES ON FOREIGN DIRECT INVESTMENT (FDI) IN CHINA"

Bonnie Jin

China has attracted a huge amount of foreign investment during the past two decades. One of the most important factors for foreign investors is China's investment policies, which change all the time. The research paper provides a review of some of the important considerations in analyzing the Chinese law, focusing on the tax policy development of foreign direct investment in PRC. Following that, the paper discusses the related reforms, especially the "tax incentives" policy, and raises issues that those "incentives" present.

"THE TAXATION OF HOSTILE INCOME TRUST MERGERS"

Brian Lindsay

The hostile takeover of an income trust is very rare. This paper considers the interaction of tax and securities law affecting such a hostile bid. Particular attention is paid to how income trusts' taxation differs from corporations' taxation in this situation. The different taxation of income trusts is found to act as a barrier to hostile takeovers bids for income trusts.

"STUDENT LOANS AND RRSPS IN THE CONTEXT OF BANKRUPTCY: THE LONG ROAD TO BILL C-55"

Ann (Margot) Lorayes

This paper examines how the treatment of outstanding student loans and Registered Retirement Savings Plans (RRSP) in the context of bankruptcy has changed over the years, as legislators try to respond to the reality of rising personal insolvency. Bill C-55, the most recent amendment to the Bankruptcy and Insolvency Act, is seen by many as a step toward the right direction. However, there remain concerns that the Canadian insolvency regime still has a long way to go in terms of achieving the appropriate balance between protecting the rights of debtors on one hand, and the interests of creditors on the other.

Student Profiles

A number of firms support UBC Tax by providing prizes and awards to students enrolled in tax law. In particular, UBC offers five tax prizes annually. Thorsteinssons LLP offers a tax prize to the top student in each section of Taxation I, and to the top student in each section of Taxation II. Stikeman Elliott LLP and Carswell offer a prize in tax law to an outstanding student in the tax law program overall at UBC.

Last year's winners of these prizes are profiled below. The recipients of the tax awards for the 2005/2006 academic year were as follows:

THORSTEINSSONS PRIZE IN TAXATION I

Josephine Chen
Shiu-Kay Hung
Rebecca Levi

THORSTEINSSONS PRIZE IN TAXATION II

Olga Bochkaryova

STIKEMAN ELLIOTT AND CARSWELL NATIONAL TAX PRIZE

Mark Barbour

JOSEPHINE CHEN

Josephine completed her B.B.A. at the Simon Fraser University, with a concentration in Accounting. During her undergraduate study, she worked at a tax accountant co-op for 8 months. She is very honoured and grateful to have received the Thorsteinssons Prize in Taxation I. She is entering her final year of law school and hopes to first pursue a career in business law. However, after more exposure to tax law practice, she may be interested in becoming a tax lawyer.



SHIU-KAY HUNG

Shiu-Kay is honoured to receive the Thorsteinssons Prize in Taxation I. He has always had a keen interest in tax, having grown up in a family of accountants. Shiu-Kay completed his LL.B. in May and is currently an articled student in the Vancouver office of McCarthy Tétrault LLP where he hopes to work on some interesting tax problems.



REBECCA LEVI

Rebecca Levi was honoured to receive the Thorsteinssons Prize in taxation. Prior to entering law school, Rebecca received a B.A. in psychology from UBC and spent a number of years conducting research in behavioral statistics. After second year of law school, she spent her summer sitting in the tax department of Blake Cassels and Graydon LLP in Vancouver, and has developed a strong interest in the practice area (honestly!). She will be clerking at the British Columbia Court of Appeal following graduation next spring, and then returning for articles at Blakes.



MARK BARBOUR

Mark Barbour received the Stikeman Elliot/Carswell National Tax Prize. While at UBC Law, Mark took all of the tax classes offered by the faculty, and completed two tax related directed research projects under the supervision of Kim Brooks. Mark is currently articling in the Toronto office of Davies Ward Phillips & Vineberg LLP where he hopes to practice in the area of taxation.



OLGA BOCHKARYOVA

Arriving originally from Vladivostok, Russia, Olga graduated from the University of Alaska, Anchorage with a BA in Justice. She started at UBC Law in 2003. This September, Olga will clerk for the Honourable Madam Justice Newbury of the BC Court of Appeal.

Although Olga does not have a background in tax either through her education or employment, she is fascinated by how tax considerations shape business decisions. It was only in taking Tax II that she began to appreciate how strongly tax savings motivate decision-makers to choose a particular corporate structure and or a form of transaction. Her other law interests include corporate and commercial law, and she considers tax issues to be key in understanding these areas.



Congratulations to **SORAYA JAMAL** (profiled in our Spring 2006 newsletter) who won the Canadian Tax Foundation-Bert Wolfe Nitikman Foundation Award for the best western Canadian student tax paper! Soraya will be articling in the Calgary office of McCarthy Tétrault LLP.

Invitation to Participate

UBC Law always has a core group of students who have a strong interest in the practice of tax either in their articling year, or in subsequent years. This year we are planning an "information and networking" event. If someone in tax at your firm would like to participate in the event, which will likely be held downtown Vancouver at Robson Square on March 1st from 6:00-7:30 pm, please email Kim Brooks (brooks@law.ubc.ca).

Supreme Court of Canada Watch

Three tax judgments remain on reserve at the Supreme Court of Canada: *Inco Ltd. v. Canada* and *Imperial Oil Ltd. v. Canada* were both heard on February 7, 2006 before Chief Justice McLachlin and Binnie, LeBel, Deschamps, Fish, Abella and Charron JJ. *Kingstreet Investments Ltd. v. New Brunswick (Department of Finance)* was heard on June 20, 2006 before Chief Justice McLachlin and Bastarache, Binnie, LeBel, Deschamps, Fish, Abella, Charron and Rothstein JJ.

The Supreme Court of Canada has granted leave to appeal in three tax cases: *3464920 Canada Inc. v. Strother, Québec (Deputy Minister of Revenue) v. Dunne*, and *Christie v. British Columbia (Attorney General)*.

Thank you to Thorsteinssons LLP for providing copies of the Income Tax Act to all students enrolled in tax classes at UBC!

National Centre for Business Law Fall 2006 Business Law Speakers' Series

UBC Robson Square
12:30 to 1:30 pm

A light lunch will be served
Tickets: \$30 each or \$100 for the series of four.

Please RSVP to: businesslaw@law.ubc.ca.

TUESDAY, OCTOBER 3

Paul Halpern, Professor of Finance and TSX Chair in Capital Markets Rotman School of Management, Toronto
The Failure of Business Trusts in the U.S. Market:
The Impact of Security Design

THURSDAY, OCTOBER 12

Ronald J. Mann, Professor, University of Texas Law School, Austin Texas
Charging Ahead: The Growth and Regulation of Payment Card Markets

WEDNESDAY, NOVEMBER 8

Christopher Hilbert, Sidley Austin LLP, New York
U.S. Securities Laws; Developments and Trends that may Impact Canada

TUESDAY, NOVEMBER 21

The Honourable James Farley, formerly of the Ontario Superior Court, Commercial List, McCarthy Tétrault, Toronto
The Future of the Oppression Remedy in Canada

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For more information about UBC's tax law program, to provide feedback or input on this newsletter, or to discuss ways your firm may get involved in UBC Tax, please contact Kim Brooks.