Dear Colleagues:

The IATJ will be holding its 3rd Assembly in Munich, Germany on October 18 and 19, 2012. The Assembly is now in the planning stages, but for your information, I can advise you that the five educational items that will likely be in the program are:

1. Judicial Independence;
2. Interpretation of Tax Treaties;
3. GAAR and judicial anti-abuse documents;
4. VAT
5. Permanent establishments – OECD commentary revisions 2014

I invite you to make suggestions for additional items in the program, alterations to the program or suggestions of speakers, but to do so as soon as possible as we are still in the planning stages.

I also invite you to solicit your colleagues, wherever they may be, for support by membership in the IATJ and I encourage your active participation in the IATJ as much as possible. Again, thank you for your continued support.

Kindest personal regards,
E.P. Rossiter, President

The 2011-2012 executive for the IATJ is:

Associate Chief Justice Eugene Rossiter (Canada), President
Judge Philippe Martin (France), 1st Vice-President;
Judge Bernard Peeters (Belgium), 2nd Vice-President;
Judge Friederike Grube (Germany), Secretary-General
Judge Willem Wijnen (Netherlands), Treasurer

executive members at large include: Judge Virgilijus Valancius (Lithuania), Judge Peter Panuthos (U.S.A.), Counsellor João Francisco Bianco (Brazil), Judge Dagmara Dominik-Ogińska (Poland), Justice Richard Edmonds (Australia), Justice Clement Endresen (Norway), Pramod Kumar (India), Judge Manuel Garzón (Spain), President Brahim Zaim, (Morocco), Dr. Manuel Luciano Hallivis Pelayo (Mexico)

Newsletter Vol. V
March, 2012

****

COPTHORNE HOLDINGS LTD. V. HER MAJESTY THE QUEEN,
[2011] S.C.J. No. 63, [2009] F.C.J. No. 625, [2007]T.C.J. No. 335

Summary of facts:

Although the facts in this appeal are quite complex, they can be summarized as follows. The Li Family controlled a group of Canadian and non-resident corporations. One of those corporations was Copthorne Holdings Ltd. (Copthorne I), a wholly-owned Canadian subsidiary of a Netherlands corporation indirectly owned by the Li family, which was incorporated in 1981 to purchase the Harbour Castle Hotel in Toronto. In 1981, the paid-up capital (PUC) of the shares of Copthorne I was $1. The PUC is an amount that can generally be distributed by a corporation to its shareholders without giving rise to a deemed dividend. In 1989, the Harbour Castle Hotel was sold, and a substantial capital gain was realized.

The Li Family had invested considerably in another Canadian corporation, VHHC Investments Inc. (VHHC Investments) and by the end of 1991, the PUC of the shares of VHHC Investments was approximately $97 million. VHHC Investments used about $67 million of these funds to purchase all the shares of another Canadian corporation, VHHC Holdings Ltd. (VHHC Holdings). Thus, at the end of 1991, the PUC of the issued shares of VHHC Holdings was approximately $67 million. VHHC Holdings held shares of Husky Oil Ltd. (Husky), a publicly traded corporation, directly and through a subsidiary, VHSUB Holdings Inc. (VHSUB) and by 1991, the fair market value of the Husky shares had fallen, with the result that VHHC Holdings owned shares of VHSUB which had a substantial capital loss.

In 1992, VHHC Investments sold VHHC Holdings to Copthorne I for $1,000. Thereafter, VHHC Holdings and Copthorne I sold all of the shares of VHSUB to a third party for a nominal consideration and realized the accrued capital loss. After all of these transactions were completed, Copthorne I owned all of VHHC Holdings, the shares of which had a nominal fair market value and a PUC of approximately $67 million.

In 1993, the Li family wanted to amalgamate VHHC Holdings, Copthorne I and two other corporations. However, under corporate law, because VHHC Holdings was wholly-owned by Copthorne I, if both corporations amalgamated, the PUC of the amalgamated corporation would have been equal to the PUC of Copthorne I (i.e., $1). If, instead, Copthorne I and VHHC Holdings were sister corporations, the PUC of their respective shares would have been aggregated. The shares of VHHC Holdings were therefore sold to the Netherlands parent of Copthorne I, Big City, for $1,000. As a result of that sale, VHHC Holdings and Copthorne I were now sister corporations. In 1994, Copthorne I, VHHC Holdings and two other corporations amalgamated under the name of Copthorne Holdings Ltd. (Copthorne II), all of the issued shares of which were owned by Big City with a PUC of approximately $67 millions.

In 1995, through a series of further restructurings by the Li family to avoid the adverse effect of the new foreign accrual property income regime on its investments, Copthorne II amalgamated with VHHC Investments to form Copthorne III. As a result, the shares of Copthorne III had a combined PUC of $164 million, representing the total PUC of the shares of VHHV Investments, VHHC Holdings and Copthorne I.

Immediately after this amalgamation, Copthorne III redeemed a number of shares held by a related Barbados corporation for approximately $142 million, and because the redemption price of each share was equal to its PUC, the redemption did not give rise to a deemed dividend under subsection 84(3) of the *Income Tax Act* (ITA). In January 2002, Copthorne III amalgamated with five other companies and continued as Copthorne Holdings Ltd.

The Minister of National Revenue assessed Copthorne Holdings Ltd. for failing to withhold and remit the withholding tax on a deemed dividend arising from the redemption of the shares that occurred in 1995. The Minister applied the General Anti-Avoidance Rule (GAAR) to deny the addition of the PUC to the extent that it included an amount of approximately $67 million that was attributable to the shares of VHHC Holdings that were transferred in the sale of shares that occurred in 1993. The Minister took the position that the 1993 sale was an abusive avoidance transaction and that the PUC of the shares of VHHC Holdings should have been reduced to nil upon its amalgamation with Copthorne I.

Tax Court of Canada Decision:

After having applied the principles for a GAAR analysis as established in the Supreme Court of Canada decisions of *Canada Trustco Mortgage Co.* v. *Canada*, [2005] 2 S.C.R. 601 and *Mathew* v. *Canada*, [2005] 2 S.C.R. 643, Justice Campbell of the Tax Court of Canada found that all conditions for the application of the GAAR were present in the case before her.

First, since there were clearly two series of transactions, one where the 1993 share sale (the alleged avoidance transaction) occurred, and the other where the redemption of the shares (the impugned tax benefit) occurred, Justice Campbell addressed the question of whether the impugned tax benefit was part of a series of transactions that included the alleged avoidance transaction. Her analysis therefore turned on the meaning of the expression "series of transactions" in subsections 245(2) and (3) of the ITA. Based on *Canada Trustco*, Justice Campbell found that a related transaction is part of a series of transactions if it is completed in contemplation of the series "not in the sense of actual knowledge but in the broader sense of 'because of' or 'in relation to' the series" and that related transactions may occur before *or* after the series. She indicated that there was a strong nexus between the redemption of the Copthorne III shares and the 1993 share sale and she therefore concluded that those transactions could be considered a "series of transactions".

Justice Campbell's analysis then turned on the question of whether it had been established that a tax benefit resulted from a transaction or part of a series of transactions (ss. 245(1) and (2) of the ITA). She indicated that the tax benefit resulted from a series of transactions which started with the preservation of the PUC and ended with the redemption of the Copthorne III shares, and that the tax benefit occurred when the artificial increase of the PUC was returned to the shareholders on a tax-free basis.

Justice Campbell continued the GAAR analysis by determining whether the series of transactions, or any transaction within the series, was an avoidance transaction as defined under ss. 245(3) of the ITA. The question that needed to be addressed was whether the alleged avoidance transaction, i.e. the 1993 share sale, could reasonably be considered to have been undertaken or arranged primarily for a *bona fide* purpose other than to obtain a tax benefit. The judge found that the 1993 share sale was not an integral component of simplifying the Li Family corporate structure. She found that the transaction had occurred for the purpose of preserving approximately $67 million in PUC which would then become an amount that could be distributed tax-free to the shareholders of the Li Family corporate group. The 1993 share sale was therefore an avoidance transaction.

The final question that needed to be addressed under the GAAR analysis was whether there was abusive tax avoidance, i.e. whether the transactions constitute an abuse or misuse within the meaning of ss. 245(4) of the ITA. Justice Campbell found that the series of transactions resulted in a misuse of ss. 89(1) which defines PUC, ss. 84(3) which is the dividend deeming section, and par. 87(3)(*a*) which deals with the computation of PUC on amalgamation. She concluded that the "overall result that the relevant provisions were meant to address has been circumvented."[1] As a

[1] *Copthorne*, TCC, para. 74.

result, Justice Campbell found that there was clearly an abuse of the ITA to which the GAAR should apply, she disallowed the addition of $67,401,279 PUC of the shares of VHHC Holdings to the PUC of the shares of Copthorne III, and she found that the subsequent redemption attributable to that same amount of PUC from VHHC Holdings was taxable.

Finally, Justice Campbell was also asked to determine whether the penalty that had been assessed by the Minister of National Revenue for failure to deduct or withhold tax under par. 227(8)(a) of the ITA should stand. The liability to pay the withholding taxes could only arise if GAAR applied. Justice Campbell indicated that an assessment under the GAAR provision could not give rise to penalties for failure to comply with the technical sections of the ITA. She also pointed out that there is nothing in the GAAR provision that allows a taxpayer to self-assess on the basis that the GAAR applies. Justice Campbell therefore concluded that a successful GAAR assessment prevents the Crown from applying penalties under ss. 227(8) of the ITA. This decision with respect to penalties was not appealed by the Crown.

Federal Court of Appeal:

The Federal Court of Appeal affirmed the Tax Court of Canada's decision, but Justice Ryer, who delivered the reasons for judgment for the Court, differed on some of the findings of the Tax Court judge. First, with respect to the question of whether the first series of transactions included the 1995 redemption by virtue of subsection 248(10) of the ITA, Justice Ryer indicated that a transaction completed after a series will be included in the series if the series is a "motivating factor" with respect to the completion of that transaction. In view of this conclusion, he found that it was unnecessary to find a strong nexus between the first series and the 1995 redemption. In any event, Justice Ryer indicated that Justice Campbell properly interpreted subsection 248(10) and made no palpable and overriding error in her application of the legal test to the facts of the case.

Then, with respect to the existence of an avoidance transaction and a tax benefit, Justice Ryer reiterated the fact that those determinations are questions of fact and that the Federal Court of Appeal cannot intervene unless the Tax Court judge committed a palpable and overriding error. Justice Ryer concluded that it was open to the Tax Court judge to conclude that because the purpose of the 1993 share sale was to preserve the PUC of the shares of VHHC Holdings, there existed an avoidance transaction, and also that the series of transactions gave rise to a tax benefit.

Finally, Justice Ryer addressed the question of whether there existed abusive tax planning for the purposes of subsection 245(4) of the ITA. Since that question was one of mixed fact and law, the judge indicated that the legal standard of review of the decision was correctness. Justice Ryer agreed with Justice Campbell's conclusion that the principles respecting the calculation of PUC were offended. He was, however, of the view that it was the provisions of paragraph 89(1) of the ITA containing the definition of PUC that was abused, not the provisions of ss. 84(3) or paragraph 87(3)(a) of the ITA. The Federal Court of Appeal therefore dismissed the appeal.

Supreme Court of Canada:

The Supreme Court of Canada unanimously confirmed the lower courts' decisions with a judgment delivered on December 16, 2011 by Justice Rothstein. Justice Rothstein first confirmed the Tax Court's finding that there was a tax benefit. He adopted the comparison approach which consists of establishing the existence of a tax benefit by comparing a taxpayer's situation with an alternative arrangement. Justice Rothstein indicated that in order to achieve the desired result, i.e. the simplification of the corporate structure, a vertical amalgamation would have been a simpler solution, but that option would have resulted in the cancellation of the PUC. It was this

fact that led to the sale by Copthorne I of its shares in VHHC Holdings to Big City (the 1993 share sale) instead. This last option resulted in a tax benefit for the taxpayer.

Then, Justice Rothstein considered whether the transaction giving rise to the tax benefit was an avoidance transaction. Two questions therefore needed to be addressed: 1-) whether there was a series of transactions that resulted in a tax benefit and 2-) whether any of the transactions within the purported series was an avoidance transaction. In response to the first question, Justice Rothstein had to determine whether the redemption of the shares, which gave rise to the tax benefit, could be considered to be a "related transaction" which was done in contemplation of the prior series of transactions pursuant to ss. 248(10) of the ITA. He agreed with the Federal Court of Appeal that a "strong nexus" is not necessary to meet the series test in *Canada Trustco*, but it does require more than a mere possibility. He also determined that nothing in ss. 248(10) specifies when the related transaction must be completed in relation to the series, and nothing requires that the related transaction must be completed in contemplation of a subsequent series. Justice Rothstein therefore agreed that the redemption of the shares was part of the same series as the 1993 share sale and amalgamation, and that series resulted in a tax benefit. In response to the second question, Justice Rothstein mentioned that he could see no error in the finding of the Tax Court judge that the 1993 share sale was not primarily undertaken for a *bona fide* non-tax purpose. He confirmed that the 1993 share sale was an avoidance transaction.

Justice Rothstein then turned to the most difficult question in this case which was whether the avoidance transaction was an abuse or misuse of the ITA. Before turning to the specific facts of this case, he summarized the principles that are applicable in that part of the GAAR analysis. First, as indicated in *Canada Trustco*, a court must determine the "objects, spirit or purpose of the provisions… that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids"[2]. In order to make that determination, the court will use the textual, contextual and purposive analysis. Second, a court must determine whether the transaction falls within or frustrates the identified purpose. Where the transaction is part of a series, the context of the series must be considered to determine whether abuse tax avoidance has occurred.

After reviewing all three sections of the ITA that were alleged to have been abused (ss. 89(1), 87(3) and 84(3)), Justice Rothstein identified ss. 87(3) as the only provision that could have been abused and then proceeded with a textual, contextual and purposive analysis of that provision. The first part of this analysis led him to conclude that the text of ss. 87(3) ensures that when corporations amalgamate, whether horizontally or vertically, the PUC of the shares of the amalgamated corporation is not inappropriately increased.

Then, Justice Rothstein considered a number of arguments made by the taxpayer in the contextual analysis of ss. 87(3) such as 1) the PUC scheme of the ITA; 2) the principle of non-consolidation; 3) the relevance of the capital gains scheme; 4) the "*In Rem*" nature of PUC; 5) stop-PUC rules in the ITA; and 6) implied exclusion. He indicated that "the necessary conclusion remains that one rationale for s. 87(3) is that payments to shareholders from an amalgamated corporation on a share redemption should not be taxable as a deemed dividend, only to the extent that such payments reflect investment made with tax-paid funds."[3]

With respect to the purpose of ss. 87(3), Justice Rothstein found that while continuity may explain part of s. 87(3) in a horizontal amalgamation, the parenthetical portion which is aimed at vertical amalgamations, prevents the preservation of the PUC of the shares of an amalgamating subsidiary, which is an additional purpose in ss. 87(3), since the PUC of a subsidiary corporation reflects the investment of the same tax-paid dollars as in the parent corporation.

---

2 *Canada Trustco*, supra, at para. 55.

3 *Copthorne*, SCC, para. 112.

After having concluded that the object, spirit and purpose of the parenthetical portion of ss. 87(3) is to preclude the preservation of the PUC of the shares of a subsidiary upon amalgamation, Justice Rothstein had to determine whether that provision had been abused in this particular case. He mentioned that the fact that a series of transactions resulted in the "double counting" of the PUC is not sufficient evidence of abuse in itself, but he agreed with the Tax Court's finding that the "double counting" was abusive in this case because the transactions were structured so that the PUC would be "artificially" preserved. He indicated that the 1993 share sale "circumvented the parenthetical words of s. 87(3) and in the context of the series of which it was a part, achieved a result the section was intended to prevent and thus defeated its underlying rationale."[4] That transaction was therefore found to be abusive. Justice Rothstein affirmed the findings of the Tax Court and the Federal Court of Appeal and dismissed the appeal.

[4] *Copthorne*, SCC, para. 127.