Avoidance rule under legal microscope

By DONALEE MOULTON

A recent decision from the Tax Court of Canada looks specifically at the issue of whether surplus funds in a family trust are treated as a capital gain or a dividend. Accountants, however, will be more interested in what the decision has to say generally about the general anti-avoidance rule (GAAR).

The particular issue before the court in *Gwartz v. Canada* [2013] T.C.J. No. 114 included the use of what is commonly called the "kiddie tax," at one time a popular way to split income. Before the case was settled, the legislation was amended, so the issue could not arise today. In the absence of this amendment, however, the Canada Revenue Agency argued the GAAR applied and the capital gain claimed by the taxpayers was an abusive anti-avoidance dodge. The tax court dismissed that argument.

"The kiddie-tax loophole has been closed, but the message is that when the department of finance amends the law they have to look broadly. They cannot look at the GAAR as a way of closing loopholes," said Wilfrid Lefebvre, a senior partner with the law firm Norton Rose Fulbright in Montreal.

In this case, the focus was on section 120.4 of the *Income Tax Act*. Brianne and Steven Gwartz had their tax returns reassessed for three years and, using the

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GAAR, the Canada Revenue Agency denied the capital gains claimed by the couple on a family trust and instead determined they were actually dividends. This, in turn, gave rise to the issue of split income and the kiddie tax. Subsequent amendments to the tax legislation did not address the issue of capital gains in cases like this (although the law does now).

"The CRA was saying the taxpayers should have known the government didn't like them to circumvent the kiddie-tax law … The court disagreed," noted Lefebvre. (The CRA declined to comment on the case, which it is currently reviewing.)

The national tax agency relied heavily on the GAAR and the government's policy directive

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that aggressive tax avoidance is not legal, even though the law at the time allowed the Gwartzes to claim the income as a capital gain. "The court looked at the gap and said when the kiddie law was first implemented it did not apply to capital gains. That was a conscious decision, so the court determined you couldn't apply the GAAR," said Glen Thompson, a tax partner with MNP LLP in Edmonton.

The court looked closely at the legislation, the amendments, and other materials supporting the new tax law. The CRA also wanted it to look closely at the policy inherent in the law. The court concluded in this case that there was no policy against surplus stripping, preferring a capital gain over a dividend, unless there is a specific anti-avoidance provision that has been circumvented, said Jehad Haymour, a tax lawyer with Dentons in Calgary. "[The decision] is again in keeping with the principle that you must first find some policy grounded in the [*Income Tax*] *Act* rather some overriding policy."

It is the court's in-depth look at anti-avoidance that may be most helpful to accountants. "The judge did a good job of analyzing the GAAR," said Kim Moody, a partner with Moodys LLP in Calgary. "It is hard to predict when you go to court how the GAAR will be interpreted. It's often called the 'sniff test.' The judge has to ask, 'Does this smell bad?' "

In his 31-page decision, Justice Robert Hogan determined that the manner in which the 2011 amendment was proposed and enacted did not suggest that the government's objective was to close a loophole. "In this case," he wrote, "Parliament moved to prevent a tax-planning strategy approximately 10 years after that strategy was first outlined publicly… [W]hen Parliament introduced section 120.4 it had to be aware that capital gains could be used to counter its operation."

Although the court's decision made it clear that the CRA could not rely on the anti-avoidance rule in *Gwartz*, there may be situations where it could. "Justice Hogan confirmed that subsequent legislative amendments may — in some cases — indicate that the subject tax-planning strategy frustrated the provisions' object, spirit and purpose. However, in other cases, the amendment may indicate that Parliament changed its mind and the amendment is intended to cover a previously uncovered situation," said Peter Aprile, principal of ATX Law in Toronto.

He points out that the court's reliance on information from a variety of sources, and not just the amendment itself, sends an important message to accountants. The court's decision regarding the potential impact of subsequent amendments and, more importantly, the significance of the commentary underlying the amendment is noteworthy, Aprile said. "If possible, tax practitioners should review any amendments and underlying material to determine exposure under the GAAR."

The decision also makes it clear that tax avoidance is legal. "There have been numerous cases, including all of the GAAR Supreme Court decisions, that have confirmed that taxpayers are entitled to arrange their affairs so as to minimize tax liability. Justice Hogan's decision in *Gwartz* applies this longstanding principle," noted Haymour.

That does not mean the CRA

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is backing down from its use of the GAAR in situations like those presented to the tax court. In an interpretation notice released by the agency, it stated that notwithstanding *Gwartz*, "The CRA intends, at the next opportunity, to demonstrate to the court that there is a specific scheme of the *Act* for taxing the distribution of surplus of a Canadian corporation as a taxable dividend in the hands of individual shareholders and that there is also an overall scheme of the *Act* against surplus stripping."

The tax agency's commitment to anti-avoidance legislation is not surprising, said Thompson, a chartered accountant. "The CRA is resorting to the GAAR much more frequently and that relates to their aggressive crackdown on tax avoidance."

The CRA's stance is unlikely to change, he added. "They are absolutely not relinquishing their position. At some point, they will have success or at some point there will be changes to the legislation. What is most likely to happen is that the department of finance will have to identify specific types of plans they don't like and specific rules to deal with them. Until then, we're going to see more cases going to court."

In the meantime, accountants may want to take a closer look at the general anti-avoidance rule and decisions like *Gwartz*. "The majority of accountants are not aware of the nuances of the GAAR," said Thompson. "A lot of accountants would be of the view that it doesn't apply to what they do. Accountants are a little naive to think that way.

"The CRA's notions of what the GAAR can apply to would surprise many accountants, even seasoned accountants," he added.

That reality raises a red flag for tax professionals who will want to have as comprehensive an understanding of the GAAR as possible, including how the courts and the Canada Revenue Agency interpret those rules. The landscape is grey and caution is required, said Moody. "There is a fine line between proper tax avoidance, improper tax avoidance, and tax evasion. You had better be aware of the boundaries and query if you are crossing a line. That's tough, and the best answers come with experience."