CESTNICK

TAX MATTERS

Court decision provides a breath of fresh air for taxpayers

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We can all use a breath of fresh air. In the world of tax planning, the air that taxpayers breathe is too often dusty, stale and rife with the government's opposition to what are legal means to pay less tax.

I often remind myself of the famous British court decision dating back to 1936, known as The Duke of Westminster case (Inland Revenue Commissioners v. Duke of Westminster). In that case, judge Lord Tomlin said: "Every man is entitled, if he can, to arrange his affairs so that the tax attaching under the appropriate acts is less than it otherwise would be."

On Sep. 13, 1988, our government introduced a tax law – the General Anti-Avoidance Rule – that has deliberately created uncertainty for taxpayers. The GAAR is designed to prevent the benefits of tax planning where that planning is within the wording of the tax law (a "textual analysis") but runs counter to the purpose or intention of the law (a "contextual and purposive analysis"). Think of this as a limit on the Duke of Westminster principle.

Every once in a while, taxpayers receive a breath of fresh air in support of the idea that the Duke of Westminster principle is not completely dead. On Nov. 26, 2021, the Supreme Court of Canada rendered a decision in Canada v. Alta Energy Luxembourg (SCC 49, 2021), that provides a small gasp of fresh air.

The GAAR

In order for the Canada Revenue Agency, or CRA, to successfully apply GAAR, three requirements have to be met:

- There must be a tax benefit.
- The transaction giving rise to the tax benefit must be an "avoidance transaction" (in the sense that it was undertaken mainly for the tax benefit and not primarily for some other bona fide purpose).
- The avoidance transaction must result in a "misuse or abuse" of the Income Tax Act (that is, obtaining the tax benefit is inconsistent with the object, spirit or purpose of the tax law).

So, to be clear, implementing tax planning is fine if it results in a tax benefit, even if the primary purpose of the planning were to obtain that benefit. The taxman will take offence, however, if the planning violates the purpose or intention of the tax law – then GAAR might be applied.

The case

The case of Alta Energy Luxembourg, or AEL, will look nothing like your personal tax situation. But the case still has relevance for Canadian taxpayers because of the principles that can be drawn from the decision. In a 6-3 majority, the Supreme Court sided with the taxpayer and reminded the CRA that the GAAR doesn't give the government the right to simply deny every form of planning that it doesn't like.

In this case, AEL, a Luxembourg company which was set up mostly by U.S. investors, carried on the business of acquiring and developing unconventional oil and natural gas properties in Canada – specifically in Alberta. The shares of AEL were owned by a Canadian partnership. Don't worry if all this sounds confusing – it is. But this structure is not the important part of the story.

Eventually, AEL sold the Alberta project and realized a large capital gain, which was reported to the Luxembourg tax authorities and was subject to tax there. No taxes were paid in Canada because Canada has a tax treaty with Luxembourg, which says that Canada does not have the right to tax capital gains that are realized by a Luxembourg resident (AEL in this case).

The CRA tried to apply GAAR to have AEL pay tax on its capital gains in Canada. AEL openly admitted that it derived a tax benefit from the company being in Luxembourg, and that there was no other primary purpose for setting up the company in that jurisdiction. So, to determine whether GAAR should apply, the court had to look at whether there was a misuse or abuse of Canadian tax law, or the tax treaty between Canada and Luxembourg.

In the end, the Supreme Court ruled that there was no such misuse or abuse of the law. Justice Suzanne Côté, writing for the majority, said: "First and foremost, tax avoidance is not tax evasion." She went on to write: "Courts should not infuse the abuse analysis with 'a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do.' Taxpayers are allowed to minimize their tax liability to the full extent of the law and to engage in 'creative' tax avoidance planning, insofar as it is not abusive within the meaning of the GAAR."

This case reminds us, and the CRA, that tax avoidance that is not abusive is perfectly fine, and that the courts – and CRA – should not determine what is abusive based simply on a value judgment about what the department, or court, thinks the law should do.

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