Docket: 2008-1667(IT)G

BETWEEN:

TRIAD GESTCO LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on April 23, 2010, at Montreal, Quebec.

Before: The Honourable Justice Réal Favreau

Appearances:

Counsel for the Appellant:	Aaron Rodgers Julie Gaudreault-Martel
Counsel for the Respondent:	Marie-Andrée Legault Justine Malone

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JUDGMENT

The appeals from the reassessments made under the *Income Tax Act*, and dated March 8, 2006 and June 8, 2006, in respect of the appellant's taxation years ended August 31, 2001, 2002 and 2003 are dismissed with costs in accordance with the attached reasons for judgment.

Signed at Ottawa, Canada, this 12th day of July 2011.

"Réal Favreau"

Favreau J.

Citation: 2011 TCC 259
Date: 20110712
Docket: 2008-1667(IT)G

BETWEEN:

TRIAD GESTCO LTD.,

Appellant,

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Respondent.

REASONS FOR JUDGMENT

Favreau J.

[1] These are appeals from reassessments made under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended (the "*Act*"), and dated March 8, 2006 for the taxation years ended August 31, 2001 and August 31, 2003, and June 8, 2006 for the taxation year ended August 31, 2002.

[2] By virtue of the reassessments dated March 8, 2006, the Minister of National Revenue (the "Minister") disallowed:

(a) the deduction of a net capital loss of $143,063 in the appellant's 2001 taxation year as a result of the denial of the capital loss claimed by the appellant for its 2002 taxation year;

(b) the deduction of a non-capital loss of $17,742 carried back from the appellant's 2003 taxation year to its 2001 taxation year;

(c) the deduction of $17,742 relating to professional fees (not in dispute in this appeal) claimed by the appellant for its 2003 taxation year.

[3] By the reassessment dated June 8, 2006, the Minister disallowed the deduction of a capital loss in the amount of $7,999,935 claimed by the appellant for its 2002 taxation year. The Minister took the position that it was a tax benefit that resulted

from a series of avoidance transactions within the meaning of section 245 of the *Act* (the "general anti-avoidance rule", referred to hereinafter as the "GAAR").

[4] In determining the appellant's tax liability for the 2001, 2002 and 2003 taxation years, the Minister made the following assumptions of fact that are set out in paragraph 13 of the Amended Reply:

a) the Appellant is a taxable Canadian corporation incorporated under the *Canada Business Corporations Act* and controlled by Peter Cohen;

b) Peter Cohen is a resident of Canada;

c) the Appellant's fiscal year end is August 31;

d) Peter Cohen is the sole director of the Appellant;

e) on December 6, 2001, the Appellant disposed of a property and realized a capital gain of $7,799,545;

Rcongold Systems Inc.

f) on July 25, 2002, Rcongold Systems Inc. ("Rcongold") was incorporated under the *Canada Business Corporations Act*;

g) Rcongold was at all material times controlled by the Appellant;

h) Peter Cohen was at all material times the director of Rcongold;

i) on August 27, 2002, the Appellant subscribed for 8,000 voting common shares of Rcongold for a total consideration of $8,000,000;

j) on August 28, 2002, Rcongold declared a dividend of $1 payable to the common shareholders by the issuance of 80,000 Class "E" non-voting preferred shares with a redemption price of $100 each;

k) the redemption price of the Class "E" non-voting preferred shares was identical to the fair market value ("FMV") of the common shares;

l) Rcongold has never filed income tax returns;

The Peter Cohen Trust

m) on August 20, 2002, the Peter Cohen Trust (the "Trust") was settled by the transfer of $100 US from Mr. Guy Carbonneau, a person not related to Peter Cohen;

n) the Trust was created for the benefit of Peter Cohen and the trustee is Sheldon Merling, a person not related to Peter Cohen;

o) the Trust has never filed income tax returns and has no business number;

p) on August 29, 2002, the Appellant sold to the Trust the 8,000 common shares in the capital stock of Rcongold for an amount of $65, which resulted in the Appellant reporting a capital loss in the amount of $7,999,935;

q) the allowable capital loss of $3,932,998 claimed by the Appellant in 2002 resulted in a net capital loss of $143,063 that the Appellant applied to reduce its tax liability for the 2001 taxation year;

r) although the Appellant claimed a capital loss of $7,999,935 in its 2002 taxation year from the disposition of the Rcongold common shares, it did not suffer any real loss;

s) the following are avoidance transactions that form part of a series that resulted in a tax benefit to the Appellant:

→ the incorporation of Rcongold;

→ the subscription by the appellant for 8,000 voting common shares in the capital stock of Rcongold for $8,000,000;

→ the creation of the Trust;

→ the payment by Rcongold of a stock dividend on the common shares by issuing 80,000 high FMV/low paid-up capital ("PUC") Class E non-voting preferred shares to the Appellant; and

→ the sale by the Appellant of the common shares of Rcongold to the Trust;

t) the transactions referred to above were not undertaken or arranged primarily for *bona fide* purposes other than to obtain a tax benefit for the Appellant; and

u) the Appellant received a tax benefit as a result of the creation of a loss of $7,999,935 on the disposition of Rcongold common shares during its 2002 taxation year.

[5] The issue to be decided is whether the appellant's loss on its disposition of the Rcongold common shares in its 2002 taxation year was nil by operation of section 245 of the *Act* such that the deduction of the loss in 2002 and the carry-back of a net capital loss in 2001 were properly denied.

Position of the Appellant

[6] The appellant submits that the following five transactions constitute the series of transactions to be considered in the context of determining whether an "avoidance transaction" exists:

a) the incorporation of Rcongold on July 25, 2002;

b) the subscription by the appellant on August 27, 2002 for 8,000 common shares of Rcongold for a total consideration of $8,000,000, the payment of which was made by the transfer of the assets listed at Tab 41 of the Joint Book of Documents;

c) the declaration by Rcongold on August 28, 2002 of a dividend of $1 payable to the appellant, as the shareholder holding all issued and outstanding common shares, by the issuance of 80,000 Class "E" non-voting preferred shares having a redemption price of $100 each;

d) the creation on August 20, 2002 of the Peter Cohen Trust ("PCT") and the transfer to it of $100 US from Guy Carbonneau, an unrelated person; the beneficiary of the PCT is Peter Cohen during his lifetime;

e) the sale by the appellant on August 29, 2002 of the 8,000 common shares of Rcongold to the PCT for an amount of $65, which represented the fair market value of the common shares at that time.

[7] The transactions described above are part of the "Reverse Freeze" put in place to ensure that any future growth of the assets of Rcongold would accrue to Peter Cohen through the PCT.

[8] The freeze of the investment of Peter Cohen in the appellant was put in place in 2000 because he had been diagnosed in 1999 with serious liver disease and a liver transplant was recommended. Mr. Cohen was placed on a liver transplant list in the fall of 1999, but was removed from the list in the spring of 2000 because of additional risk factors.

[9] The appellant is a corporation created under the *Canada Business Corporations Act* ("CBCA") to own and manage real estate. Peter Cohen was the sole shareholder of the appellant, holding 10 Class "A" shares and 30 Class "F" shares. The fiscal year-end of the appellant is August 31 of each year.

[10] Peter Cohen's interest in the appellant was frozen at fair market value - which was estimated to be $4 million as at June 22, 2000 - in favour of Peter Cohen's children (the "Freeze"). The Freeze was realized by the execution of the following transactions:

a) A family trust was created by a trust deed dated June 21, 2000, the beneficiaries of which trust were Peter Cohen's children.

b) By a resolution dated June 22, 2000, 10 Class "A" shares of the appellant were converted into 10 Class "F2" shares of the appellant; the Class "F2" shares carried a non-cumulative dividend of 0.4% per month and were non-participating, non-voting and redeemable, at the option of the holder or the company, at the fair market value of the consideration received in exchange therefor, as determined by the express resolution of the directors ($400,000 per share for a total of $4,000,000).

c) On June 22, 2000, Peter Cohen subscribed for 1,000 Class "C" shares of the appellant at the price of $100 in the aggregate. The Class "C" shares carried a non-cumulative dividend of 0.5% per month and were non-participating, voting, and redeemable, at the option of the company, at the issue price.

d) On June 22, 2000, Peter Cohen, as trustee of the Peter Cohen Family Trust, subscribed for 30 Class "B" shares of the appellant at the price of $1 per share. The Class "B" shares were participating but non-voting.

[11] As a result of the Freeze, Peter Cohen was holding 1,000 Class "C" shares, 10 Class "F2" shares and 30 Class "F" Shares of the appellant, and the Peter Cohen Family Trust was holding 30 Class "B" shares. The Class "F" shares carried a

non-cumulative dividend of 0.5% per month and were non-participating, non-voting, and redeemable, at the option of the holder or the company, at the issue price.

[12] During the period between the Freeze and the Reverse Freeze, the following transactions were executed:

a) On December 6, 2001, a property located at 8 500 Decarie Blvd., in the town of Mont-Royal, was sold by the appellant to Cominar Real Estate Investment Trust, a party not related to the appellant, for a selling price of $32,650,000, which transaction gave rise to a capital gain of $7,799,545.

b) On January 9, 2002, the appellant redeemed 30 Class "F" shares and 10 Class "F2" shares of its capital stock registered in the name of Peter Cohen. The 30 Class "F" shares had an aggregate redemption value of $540,597 and a paid-up capital of $30. The 10 Class "F2" shares had an aggregate redemption value of $4,000,000 and a paid-up capital of $10. The redemption of the 30 Class "F" shares and the 10 Class "F2" shares gave rise to a deemed dividend of $4,540,557, which was treated by the appellant as being a dividend paid out of its capital dividend account, and consequently the deemed dividend was a tax-free dividend in the hands of Peter Cohen.

c) On January 18, 2002, Peter Cohen subscribed for 3,000,000 Class "E" shares of the appellant at a price of $1 per share. The Class "E" shares carried a non-cumulative dividend of 6% yearly, were redeemable and retractable at the price paid for them, and were voting preferred shares.

[13] As a result of the transactions described in the immediately preceding paragraph, Peter Cohen was holding 1,000 Class "C" shares and 3,000,000 Class "E" shares of the appellant and the Peter Cohen Family Trust was holding 30 Class "B" shares of the appellant. Peter Cohen's interest in the appellant was limited to $180,000 generated annually (6% on 3,000,000 Class "E" shares), which he considered to be insufficient to maintain his standard of living and to pay the cost of medical treatment that could become available in the United States if he was to survive longer than anticipated.

[14] The appellant submits that section 245 of the *Act* does not apply to the Reverse Freeze as there is no avoidance transaction or misuse or abuse of any provision of the *Act*, or of the *Act* read as a whole. None of the transactions which resulted in the

future growth of Rcongold being available to Peter Cohen are avoidance transactions and those transactions were undertaken primarily for non-tax purposes.

[15] The appellant refers to the following extracts from *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601 ("*Canada Trustco*"), at paragraphs 13 and 17, to explain the intent of the GAAR provision and the requirements that must be met in order for the GAAR to apply:

> […] This is a broadly drafted provision, intended to negate arrangements that would be permissible under a literal interpretation of other provisions of the *Income Tax Act*, on the basis that they amount to abusive tax avoidance. […]
>
> […]
>
> The application of the GAAR involves three steps. The first step is to determine whether there is a "tax benefit" arising from a "transaction" under s. 245(1) and (2). The second step is to determine whether the transaction is an avoidance transaction under s. 245(3), in the sense of not being "arranged primarily for *bona fide* purposes other than to obtain the tax benefit". The third step is to determine whether the avoidance transaction is abusive under s. 245(4). All three requirements must be fulfilled before the GAAR can be applied to deny a tax benefit.

[16] The appellant submitted an analysis of each of the requirements of the *Canada Trustco* decision in the context of the facts pertaining to the Reverse Freeze.

<u>Tax Benefit</u>

[17] The appellant referred to the following extract from the *Canada Trustco* decision dealing with “tax benefit”:

> 19 "Tax benefit" is defined in s. 245(1) as "a reduction, avoidance or deferral of tax" or "an increase in a refund of tax or other amount" paid under the Act. Whether a tax benefit exists is a factual determination, initially by the Minister and on review by the courts, usually the Tax Court. The magnitude of the tax benefit is not relevant at this stage of the analysis.

[18] The appellant argues that no tax benefit as contemplated by section 245 of the *Act* resulted from the Reverse Freeze because the capital loss of $7,999,935 triggered by the disposition of common shares of Rcongold by the appellant to the PCT in 2002 gives rise neither to a reduction nor to a deferral of “tax or other amount payable” as no amount was payable in respect of capital gains at the time of the

transaction. The capital loss does not, in and of itself, give rise to an "increase in a refund of tax". If a refund of tax was granted to the appellant on the basis of the capital loss, such a refund would be the result of the application of the loss carry-back (or carry-forward) provision, which application is not a transaction and cannot therefore result in a "tax benefit" as contemplated by section 245 of the *Act*.

Avoidance Transaction

[19] The appellant argues that, for the GAAR to apply, at least one transaction in a series of transactions must be an "avoidance transaction", and in that case the tax benefit that results from a series of transactions may be denied under the GAAR. Conversely, if each transaction in a series was carried out primarily for *bona fide* non-tax purposes, the GAAR cannot be applied to deny a tax benefit. To determine whether an "avoidance transaction" exists, each transaction must be examined, without regard to its tax implications, to determine whether its economic substance was what it purported to be.

[20] According to the appellant, the purpose of the series of transactions was clearly a non-tax purpose, namely to allow any future increase in the value of Rcongold to accrue to Peter Cohen. It was a transfer from Peter Cohen's children to him. Consequently, the result of the series cannot be questioned. All of the steps taken in furtherance of the Reverse Freeze had the economic substance they purported to have, were legally effective, and were necessary to achieve the non-tax purpose.

[21] The incorporation of Rcongold and the issuance of common shares of that corporation were not avoidance transactions. The real economic effect was that assets were transferred to Rcongold in exchange for shares issued from treasury.

[22] The declaration and payment of a stock dividend was an effective legal transaction carrying with it economic substance. This is a normal feature of any freeze allowing the transfer of values between family members. The amount of the dividend, which determines the paid-up capital, was set precisely so that the Reverse Freeze could be achieved without tax being immediately payable.

[23] According to the appellant, each transaction in the series would have been undertaken even in the absence of any "tax benefit". In the absence of a capital loss for the appellant, the Reverse Freeze would have been an effective solution to the problem perceived by Peter Cohen and his children. It allowed the appellant to

maintain its business assets while allowing Peter Cohen to obtain the benefits of future growth on the unanticipated gains realized by the appellant.

Abuse

[24] The third requirement for the application of the GAAR is that the avoidance transaction or series must be abusive. An abuse analysis is only relevant where an avoidance transaction and a "tax benefit" are present, and their presence is expressly denied by the appellant. Abuse can only be found where the avoidance transaction frustrates a clear legislative policy the existence of which must be anchored in the wording of the *Act*. The *Canada Trustco* decision explicitly rejected an economic substance test with respect to abuse.

[25] The appellant states that the GAAR is applicable only if it can be shown that Parliament intended to deal with the matters and attempted to do so, but its efforts fell short. The repeal of subsection 55(1) of the *Act* and the existence of subsection 15(1.1) tend to indicate the contrary: Parliament was clearly aware of the problem, but made no effort to deal with it.

[26] The appellant refers to the following statements made by the Supreme Court of Canada in the *Canada Trustco* decision, at paragraphs 43 and 55:

> 43. […] Section 245(4) requires a single, unified approach to the textual, contextual and purposive interpretation of the specific provisions of the *Income Tax Act* that are relied upon by the taxpayer in order to determine whether there was abusive tax avoidance.
>
> […]
>
> 55. In summary, s. 245(4) imposes a two-part inquiry. The first step is to determine the object, spirit or purpose of the provisions of the *Income Tax Act* that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids. The second step is to examine the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue.

[27] The appellant further states that:

> The burden is on the Minister to establish abuse and to state which provision of the Act could have been abused.

> GAAR must be applied in a manner which ensures consistency, predictability and fairness in tax law.
>
> Where the existence of abusive tax avoidance is unclear, the benefit of the doubt must favour the Taxpayer.
>
> No economic substance or business purpose analysis is appropriate in the context of the abuse analysis.

Specific provisions

[28] The appellant further argues that the transactions have not resulted, directly or indirectly, in a misuse or an abuse of paragraphs 40(1)(*b*), 38(*b*) and 39(1)(*b*) and subparagraph 3(*b*)(ii) of the *Act*.

[29] The capital loss realized by the appellant resulted from the application of the *Act* in determining the adjusted cost base of the common shares of Rcongold without regard to the stock dividend. The CBCA allows the taxpayer to pay such a dividend. The reduction in value of the common shares arising from the stock dividend results only from the mechanism provided for by the CBCA.

[30] The appellant relied on the net capital loss carry-back provision in paragraph 111(1)(*b*) of the *Act*, and on the definition of net capital loss in subsection 111(8). The text and context of subsections 111(1) and 111(8) of the *Act* reveal that Parliament's purpose and intent was to permit taxpayers to carry a net capital loss backward for three years and forward indefinitely. The appellant cannot have abused paragraph 111(1)(*b*) of the *Act* or frustrated Parliament's intent with respect thereto by behaving in exactly the way which Parliament intended.

Other Points

[31] The Reverse Freeze should not be considered as an abuse of the provisions of the *Act*. The purpose of the transactions was not to create a loss but to effect a freeze. The appellant's transactions had real economic substance: the common shares of Rcongold were transferred to the PCT for a real consideration after a dividend was in fact paid by the issuance of preferred shares. Accordingly, there is nothing "artificial" or "abusive" about the transactions.

Position of the Respondent

[32] The respondent argues that:

a) The appellant entered into a series of avoidance transactions the main purpose of which was the creation of an artificial capital loss to offset a capital gain which had been made in the same taxation year.

b) The Appellant's assertion that the transactions in issue were designed to effect the reversal of an earlier estate freeze is not supported by the evidence and fails to explain how the creation of an artificial capital loss achieved the stated estate planning objectives of its controlling shareholder, Peter Cohen.

c) The tax benefit that resulted from the series of transactions, namely, the creation of a capital loss in the amount of $7,999,935 which was applied to offset a capital gain of a similar amount, goes beyond the ambit of permissible estate planning. The transactions in issue were specifically undertaken to avoid the payment of tax on a capital gain, and the series as a whole results in a misuse and abuse of the *Act* read as a whole and of the provisions dealing with the creation of capital gains and losses.

[33] The respondent states that the GAAR denies the tax benefit sought by a taxpayer where:

a) a tax benefit arises from a transaction or a series of transactions (subsections 245(1) and (2));

b) the transaction, alone or as part of a series, is an avoidance transaction, as defined in subsection 245(3); and

c) the avoidance transaction results in a misuse or abuse within the meaning of subsection 245(4).

[34] According to the respondent, the taxpayer bears the burden of demonstrating that the first two criteria are not met, while the burden is on the Minister to prove, on the balance of probabilities, that the avoidance transaction results in a misuse or abuse within the meaning of subsection 245(4).

<u>Tax Benefit</u>

[35] The expression “tax benefit” is defined in subsection 245(1) as “a reduction, avoidance or deferral of tax” or “an increase in a refund of tax or other amount” paid under the *Act*. The determination whether a tax benefit exists is a factual determination. As stated by the Supreme Court of Canada in the *Canada Trustco* decision at paragraph 20:

> If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. […]

[36] According to the respondent, the tax benefit in this case arose from the offsetting of the capital gain of $7,799,545 and the reduction to nil of the tax that would otherwise have been payable on that gain.

[37] In order for subsection 245(2) to apply to a transaction, it is sufficient that the reduction, avoidance or deferral of tax result directly or indirectly, from an avoidance transaction or from a series of transactions of which the avoidance transaction is a part.

<u>Avoidance Transaction</u>

[38] The respondent states that to determine whether a transaction or any transaction in a series of transactions is an “avoidance transaction” under subsection 245(3) in the sense of not being "arranged primarily for *bona fide* purposes other than to obtain the tax benefit", it is necessary to examine the primary purpose of each transaction. The entire series need not be an avoidance transaction as long as one transaction in the series was not undertaken primarily for *bona fide* purposes other than to obtain the tax benefit.

[39] Even where a *bona fide* non-tax purpose to the series of transactions is found to exist, if the primary purpose of at least one transaction in the series is to obtain a tax benefit, the tax benefit that results from the entire series may be denied under the GAAR.

[40] The respondent argues that there are at least three clearly identifiable avoidance transactions in the series of transactions entered into by the appellant:

– the payment by Rcongold of a stock dividend;

– the creation of the PCT;
– the disposition of the common shares of Rcongold to the PCT.

[41] The only purpose of the payment by Rcongold of a stock dividend in the amount of $1 on the common shares held by the appellant through the issuance of 80,000 high fair market value/low paid-up capital Class "E" non-voting preferred shares to the appellant was to shift the value of the common shares to the preferred shares (the "value/shift") and to create a latent capital loss which the appellant could then realize on the disposition of the common shares to the PCT.

[42] The only purpose of the creation of the PCT was to allow the recognition and realization of the capital loss of $7,999,935 on the disposition of the common shares of Rcongold to the PCT. This is evident because the loss could not have been realized had the shares been sold directly to Peter Cohen, his spouse or a company controlled by Peter Cohen or his spouse. That is because subsection 251.1(1) of the *Act* did not include, in 2002, the reference to a trust in the definition of "affiliated persons". Paragraphs 251.1(1)(*g*) and (*h*) were added by S.C. 2005, c. 19, s. 54(1) applicable in determining whether persons are, at any time after March 22, 2004, affiliated.

[43] The disposition of the common shares of Rcongold to the PCT rather than to Mr. Cohen personally, or to a company controlled by him, was undertaken to avoid the application of the stop-loss rules in subparagraph 40(2)(*g*)(i) and to permit the recognition of the capital loss under the technical provisions of the *Act*.

[44] According to the respondent, it is reasonable to conclude that the value/shift, the creation of the PCT and the disposition of the common shares to the PCT were not undertaken or arranged primarily for *bona fide* purposes other than to obtain a tax benefit. These were accordingly avoidance transactions within the meaning of subsection 245(3) of the *Act*.

[45] The respondent further submits that the primary purpose of the entire series of transactions was to obtain the tax benefit and that the entire series is an avoidance transaction. The facts of this case suggest that the entire series of transactions was undertaken primarily to obtain the tax benefit rather than to allow Mr. Cohen to access the future growth on $8 million. None of the transactions were primarily undertaken to allow Peter Cohen to access funds which he had relinquished in the course of the estate freeze that occurred in 2000, as there is no evidence that Mr. Cohen actually took steps to access those funds.

[46] The respondent also argues that a reversal of the estate freeze could have been accomplished in many other ways under the provisions of the *Act* without adverse tax consequences and without the creation of a capital loss.

[47] The respondent states that the manner in which the appellant and Mr. Cohen undertook the series of transactions discloses that it was carried out for the sole purpose of obtaining the tax benefit. To realize a capital loss equal to the amount of the gain realized weeks before, it was essential that the transactions unfold the way they did. The transactions were, however, not required in order to allow Mr. Cohen to access the future growth of the appellant.

[48] According to the respondent, it is possible and reasonable in this case to conclude that the tax benefit is the only reason the transactions were arranged in the manner chosen by Mr. Cohen and his tax advisors. For the appellant to be successful, the evidence must show that the non-tax business objectives of the appellant required each specific step in the series to be taken.

[49] Even if a *bona fide* non-tax purpose was found to exist for the series of transactions as a whole, the creation of the loss and the presence of at least three clear avoidance transactions trigger the application of subsection 245(2) of the *Act*.

<u>Abusive tax avoidance</u>

[50] The third step in the GAAR analysis is the determination whether the avoidance transactions giving rise to a tax benefit are abusive. The focus of the analysis must be on the overall result of the series as opposed to the overall purpose.

[51] The analysis under subsection 245(4) requires a determination whether the transactions frustrate the object, spirit and purpose of the relevant provisions of the *Act*, which in turn requires an examination of the factual context of the transactions, their legitimacy and the result that those provisions sought to achieve. The analysis under subsection 245(4) is a two-step analysis.

[52] The first step requires, in order to determine their object, spirit and purpose, a textual, contextual and purposive approach to interpreting the provisions of the *Act* relied upon by the appellant in seeking to obtain the tax benefit. The respondent refers to the introduction of a tax on capital gains as part of the 1972 tax reform, which was accompanied by the fiscal recognition of capital losses upon their being

incurred and by the enactment of specific anti-avoidance provisions relating to capital losses (sections 54 and 55 and paragraph 40(2)(*g*)).

[53] Section 55 was enacted to prevent capital losses from being artificially created to offset capital gains. Any capital loss realized on a disposition in circumstances that could reasonably be considered to have artificially or unduly created that loss was deemed to be non-existent. In 1980, the *Act* was amended to, *inter alia*, broaden the scope of the anti-avoidance rule in section 55 by the enactment of subsection 55(2).

[54] Subparagraph 40(2)(*g*)(i) and section 54 deem superficial losses to be nil. Those rules along with section 251.1, which was added to the *Act*, continue to remain in effect and were in effect under the *Act* as it read in 2002.

[55] A contextual and purposive interpretation of the provisions relied on by the appellant in seeking to obtain the tax benefit discloses that their object, spirit and purpose was to allow only the recognition of true capital losses incurred outside the same economic unit.

[56] A contextual and purposive reading of sections 3, 38 (more specifically paragraph 38(*b*)), 39 and 40 must take into consideration their legislative history and context and their interplay with subparagraph 40(2)(*g*)(i), section 54, former subsection 55(1) and section 251.1. Such a reading leads to the conclusion that the recognition of artificial losses realized within the same economic unit is contrary to the object, spirit and purpose of those provisions.

[57] The second step in the analysis under subsection 245(4) is to examine the factual context of this case in order to determine whether the avoidance transactions undertaken by the appellant defeat or frustrate the object, spirit or purpose of the provisions in issue. Where a taxpayer has relied on a series of transactions to obtain a tax benefit, the entire factual context of the series must be examined.

[58] The transactions undertaken by the appellant amount to abusive tax avoidance for the following reasons:

a) They defeat the underlying rationale of the capital loss treatment provided for in paragraph 38(*b*), which is only to allow the recognition of a true capital loss. The appellant transferred artificially devalued shares of Rcongold that had been held by the appellant for a mere 24 hours to a person within the same economic unit in order to create a capital loss without incurring any economic loss. The recognition of a capital loss resulting from the series of transactions is inconsistent with the underlying object, purpose and spirit of the tax benefit provision found in paragraph 38(*b*), which was enacted concurrently with anti-avoidance provisions aimed at preventing a taxpayer from deducting artificially created capital losses or capital losses realized within the same economic unit.

b) They achieve an outcome that the stop-loss rules and other specific anti-avoidance provisions, found notably in subparagraph 40(2)(*g*)(i), seek to prevent, that is, the deduction of a loss created within the same economic unit in a manner that frustrates or defeats the object, spirit or purpose of those provisions.

[59] The respondent further states that the artificiality and vacuity of the “loss” manufactured in this case is an important factor in the examination of the factual context of the case to determine whether the avoidance transaction defeats or frustrates the object, spirit or purpose of the provisions in issue and results in a misuse and abuse of the provisions of the *Act*, read as a whole. The respondent refers to several cases in which the courts have considered the artificiality of transactions undertaken by taxpayers in order to obtain a tax benefit or circumvent specific provisions of the *Act*, in particular the Supreme Court of Canada’s decision in *Mathew v. Canada*, [2005] 2 S.C.R. 643, 2005 SCC 55, in which the abusive nature of the transactions was confirmed "by the vacuity and artificiality of the non-arm’s length aspect of the initial relationship".

[60] The respondent further submits that the continued intention of Parliament with respect to deductible capital losses is that this tax benefit should only apply in circumstances where the loss is not created artificially. The respondent’s reasoning is based on former section 55, renumbered subsection 55(1) in 1980, which was an anti-avoidance provision directed against transactions that could reasonably be considered to result in the artificial or undue reduction of a capital gain or creation of a capital loss. The result of the application of subsection 55(1) was that the taxpayer’s gain or loss from the disposition of the property was computed as if the artificial or undue reduction of the taxpayer’s gain, or creation or increase of the taxpayer’s loss, had not occurred.

[61] Former subsection 55(1) was repealed upon the enactment of the general anti-avoidance rule in section 245.

[62] The repeal of former subsection 247(1) and its replacement with section 245 did not signal that the strictures against surplus stripping were being relaxed. The same conclusion should be drawn with respect to the repeal of subsection 55(1) and its replacement with section 245.

[63] The respondent also argues, on the basis of the decisions of the Supreme Court of Canada in *Lipson v. Canada*, [2009] 1 S.C.R. 3, 2009 SCC 1, and *Canada Trustco*, cited above, that an abuse may result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions. In this case, the anti-avoidance provisions that the appellant seeks to circumvent are the stop-loss provisions. These stop-loss rules deem a capital loss to be nil and aim at denying or limiting the deductibility of losses arising from the disposition of capital property in circumstances where the disposition occurred within a group of certain non-arm's length parties.

[64] Pursuant to subparagraph 40(2)(*g*)(i) and the definition of "superficial loss" in section 54, a taxpayer's loss on the disposition of property to an affiliated person, as defined in subsection 251.1(1), is deemed to be nil. Subparagraph 40(2)(*g*)(i) did not apply to deny the loss on the disposition of the common shares of Rcongold to the PCT in 2002 because, at the time that the transaction occurred, the PCT and the appellant were not included within the ambit of the definition of "affiliated persons" in subsection 251.1(1), as it read at the time.

[65] The definition of "affiliated persons" in section 251.1 was amended in 2005 to include trusts. The amendments were aimed primarily at disallowing losses on transactions carried out between related persons through the use of a trust, which transactions previously circumvented the anti-capital gain stripping tax policy considerations underlying, *inter alia*, subparagraph 40(2)(*g*)(i). Subsection 251.1(1) now ensures that transactions between a trust and a person with whom it is "affiliated" will be subject to the "stop-loss" rules contained in the *Act*. The loss on the disposition of the shares to the PCT for the benefit of Mr. Cohen would now be deemed to be nil. The amendment of section 251.1 is an indication that the results achieved by the appellant were contrary to the object, spirit and purpose of the *Act*, read as a whole.

<u>Analysis</u>

[66] The Minister's reassessment dated June 8, 2006 was based on section 245 of the *Act* which provides as follows:

> **245. [General Anti-Avoidance Rule - GAAR] — (1) Definitions —** In this section,
>
> **"tax benefit"** means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty;
>
> **"tax consequences"** to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount;
>
> **"transaction"** includes an arrangement or event.
>
> (2) **General anti-avoidance provision [GAAR] —** Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.
>
> (3) **Avoidance transaction —** An avoidance transaction means any transaction
>
> (*a*) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or
>
> (*b*) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.
>
> (4) **Application of subsec. (2) —** Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction
>
> (a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of
>
> (i) this Act,
> (ii) the *Income Tax Regulations,*
> (iii) the *Income Tax Application Rules,*
> (iv) a tax treaty, or
> (v) any other other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in

> determining any amount that is relevant for the purposes of that computation; or
>
> (b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.
>
> (5) **Determination of tax consequences —** Without restricting the generality of subsection (2), and notwithstanding any other enactment,
>
> (*a*) any deduction, exemption or exclusion in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,
> (*b*) any such deduction, exemption or exclusion, any income, loss or other amount or part thereof may be allocated to any person,
> (*c*) the nature of any payment or other amount may be recharacterized, and
> (*d*) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,
>
> in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

Tax benefit

[67] In applying the approach suggested by the Supreme Court in *Canada Trustco*, the first question to be determined is whether the appellant obtained a tax benefit from a transaction or part of a series of transactions. In determining what constitutes a series of transactions, consideration should be given to subsection 248(10) of the *Act*, which states that:

> (10) For the purposes of this Act, where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series.

[68] In this instance, there is no dispute between the parties that the series of transactions to be considered consists of the five transactions forming part of the Reverse Freeze namely: the incorporation of Rcongold, the subscription for shares of Rcongold by the appellant, the declaration of a stock dividend by Rcongold, the creation of the PCT, and the sale by the appellant of shares of Rcongold to the PCT.

[69] In order for a "tax benefit" to exist, a reduction, avoidance or deferral of tax is required. The Supreme Court of Canada clearly stated in *Canada Trustco* that, where a deduction against taxable income is claimed, the existence of a tax benefit is clear since a deduction results in a reduction of tax. In the absence of the transactions forming part of the Reverse Freeze, the appellant would have had to pay tax on a capital gain of $7,799,545. Instead, a capital loss of $7,999,935 was created and made available to the appellant to apply against its capital gain. The tax benefit arose from the offsetting of the capital gain against the capital loss and the reduction to nil of the tax that would otherwise have been payable on that gain.

<u>Avoidance transaction</u>

[70] The next step in the GAAR analysis is to determine whether a transaction or any transaction in a series of transactions is an "avoidance transaction" under subsection 245(3), in the sense of not having been "arranged primarily for *bona fide* purposes other than to obtain the tax benefit". The determination that must be made is the primary purpose of each transaction in the series and not the primary purpose of the entire series.

[71] The incorporation of Rcongold and the issuance of common shares of Rcongold were not avoidance transactions in and of themselves. They were legally effective transactions having the economic substance they purported to have. However, they were necessary steps taken in furtherance of the Reverse Freeze and, for that reason, they were part of the series of transactions.

[72] The declaration by Rcongold, the day after the common shares were subscribed for, of a dividend of $1 on the common shares held by the appellant and the payment of the dividend on the same day by issuing 80,000 high FMV/low PUC Class "E" non-voting preferred shares of the appellant was an avoidance transaction aimed at shifting the value of the common shares to the preferred shares and creating a latent capital loss which the appellant could then realize on the disposition of the common shares to the PCT. The real economic effect of these transactions was the payment of a $1 dividend by means of 80,000 preferred shares having a redemption price and a fair market value of $8,000,000.

[73] The creation of the PCT was also an avoidance transaction since the only purpose of the PCT was to allow the recognition and realization of the capital loss of $7,999,935 on the disposition of the common shares of Rcongold.

[74] The sale of the common shares of Rcongold to the PCT was an avoidance transaction undertaken primarily to realize a capital loss on the common shares while avoiding the application of the stop-loss rules found in subparagraph 40(2)(*g*)(i) and to permit the recognition of the capital loss under the technical provisions of the *Act*.

[75] In my opinion, it is reasonable to conclude that the value/shift, the creation of the PCT and the disposition of the common shares to the PCT were not undertaken or arranged primarily for *bona fide* purposes other than to obtain a tax benefit, and that the primary purpose of the entire series of transactions was to obtain the tax benefit. Consequently, the entire series of transactions is an avoidance transaction.

[76] The facts of this case suggest that the entire series of transactions was undertaken primarily to obtain the tax benefit rather than to allow Mr. Cohen to access the future growth on $8 million worth of assets. None of the transactions were primarily undertaken to allow Mr. Cohen to access funds which he had relinquished in the course of the estate freeze that occurred in 2000, and there is no evidence that Mr. Cohen actually took steps to access those funds.

[77] At the time the series of transactions was entered into, Mr. Cohen had access, on a tax-free basis, to $3 million upon redemption of the Class "E" preferred shares of the appellant. The Class "E" preferred shares had a paid-up capital, a redemption price and an adjusted cost base of $3,000,000. They were voting shares, redeemable, at the option of the holder or the company, at the issue price, and they were non-participating except for a non-cumulative 0.5% per month dividend. They were subscribed and paid for by Mr. Cohen on January 18, 2002. The $3,000,000 subscription price paid for the said preferred shares came partly or entirely from the redemption on January 9, 2002 of the 30 Class "F" shares and 10 Class "F2" shares of the appellant held by Mr. Cohen for $540,597 and $4,000,000, respectively. The said share redemptions triggered two deemed capital dividends (and thus tax-free in the hands of Mr. Cohen) pursuant to elections made under subsection 83(2) of the *Act*. For tax purposes, the two deemed dividends were considered to have been paid out of the appellant's capital dividend account that was created as a result of the sale of the real property on December 6, 2001. As suggested by the appellant's tax advisors, the capital dividend account of the appellant had to be distributed prior to the creation of the capital loss in order to avoid the reduction of the account balance.

[78] As described above, Mr. Cohen received from the appellant a total of $4,540,597 during the month of January 2002 and reinvested only $3,000,000 in Class "E" shares of the appellant generating a monthly dividend of $15,000. In the

circumstances, I have some difficulty accepting that Mr. Cohen absolutely needed to have access to the future growth on $8,000,000.

[79] The facts concerning the growth of the assets transferred to Rcongold show that the growth was uncertain and that the assets transferred were not a reliable source of income. Approximately 10% of the assets transferred were not generating any income at all and had an uncertain value. Those assets were interest-free loans to related companies or to members of Mr. Cohen's family. From the tax returns filed by Rcongold on August 23, 2006 for its 2002, 2003, 2004 and 2005 taxation years, the after-tax net income (loss), the retained earnings, the share redemptions and the taxable dividends paid in those years were as follows:

Year-end (August 31)	**Net income or loss $**	**Retained earnings $**	**Share redemptions**	**Taxable dividends paid**
2002	(220)	(220)	Nil	Nil
2003	44,004	24,784	Nil	Nil
2004	184,878	203,662	Nil	Nil
2005	31,360	230,022	Nil	Nil

[80] The information contained in the tax returns of Rcongold clearly shows that the $8,000,000 in assets generated very little income and that in fact Mr. Cohen took no steps to access those funds.

[81] A reversal of the earlier estate freeze could have been accomplished in many other ways under the provisions of the *Act* and without the creation of a capital loss. For example, a new freeze could have been carried out by having the appellant roll over to a new corporation (Newco), all (complete freeze) or part (partial freeze) of its assets in exchange for preferred shares of Newco having a redemption price equal to the fair market value of the assets transferred to Newco. Mr. Cohen could then have subscribed for common shares of Newco for a nominal amount. Alternatively, the Peter Cohen Family Trust could have exchanged its common shares of the appellant for preferred shares by using the rollover provisions of sections 51, 85 or 86 of the *Act*. Mr. Cohen could then have subscribed for common shares in the appellant for a

nominal amount. This would have allowed Mr. Cohen to participate in the future growth of the appellant as of the date of those transactions.

[82] The manner in which the appellant and Mr. Cohen undertook the series of transactions reveals that the transactions were carried out in that way for the sole purpose of obtaining the tax benefit. In order to realize a capital loss equal to the amount of the gain previously realized, it was essential that the transactions unfold the way they did. The transactions were not required in order to allow Mr. Cohen to access the future growth of the assets of the appellant.

[83] In the circumstances, it is reasonable to conclude that the realization of the tax benefit was the only reason the transactions were arranged in the manner chosen by Mr. Cohen and his tax advisors.

Misuse or abuse

[84] The third requirement for the application of the GAAR is that the avoidance transaction or series of transactions be abusive. The burden is on the Minister to establish the abuse and to state which provisions of the *Act* have been abused.

[85] With the inclusion, as of 1972, of taxable capital gains in the calculation of income and with the existence of the ability to have those gains offset by deductible capital losses incurred in the year, specific anti-avoidance provisions relating to capital losses were enacted. These provisions included former section 55, paragraph 40(2)(*g*) and section 54 of the *Act*.

[86] Former section 55 of the *Act* was enacted to prevent capital losses from being artificially created in order to offset capital gains. Any capital loss realized on a disposition in circumstances that could reasonably be considered to have artificially or unduly created that loss was deemed to be non-existent.

[87] Former section 55, renumbered 55(1) in 1980, provided as follows:

> For the purposes of this subdivision, where the result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatever is that a taxpayer has disposed of property under circumstances such that he may reasonably be considered to have artificially or unduly
>
> (*a*) reduced the amount of his gain from the disposition,
> (*b*) created a loss from the disposition, or

> (*c*) increased the amount of his loss from the disposition,
>
> the taxpayer's gain or loss, as the case may be, from the disposition of the property shall be computed as if such reduction, creation or increase, as the case may be, had not occurred.

[88] Former subsection 55(1) was repealed upon the enactment of the general anti-avoidance rule in section 245. The Department of Finance Technical Notes for 1988 with respect to former subsection 55(1) reads as follows:

> Subsection 55(1) of the Act is an anti-avoidance provision aimed at transactions designed to artificially or unduly reduce a capital gain or increase or create a capital loss on a disposition of property.
>
> Subsection 55(1) is repealed as a consequence of the introduction of new section 245 of the Act, which constitutes a general anti-avoidance rule. Because the scope of that general anti-avoidance rule is broad enough to cover the transactions to which subsection 55(1) was intended to apply, that subsection is no longer necessary. Subsection 55(1) is repealed.

[89] The repeal of subsection 55(1) and its replacement with section 245 did not signal a policy shift. On the contrary, it confirmed the continued intention of Parliament with respect to deductible capital losses that this tax benefit should only apply in circumstances where the loss is not created artificially.

[90] The other specific anti-avoidance provisions relating to capital losses that were enacted by Parliament are subparagraph 40(2)(*g*)(i) and section 54 (generally referred to as the stop-loss provision). The concept of "affiliated persons" was introduced into the *Act* in 1995 primarily in support of a number of new and amended anti-avoidance provisions, most of which are stop-loss provisions.

[91] In 2002, subparagraph 40(2)(*g*)(i) read as follows:

> Notwithstanding subsection (1)
>
> . . .
>
> (*g*) a taxpayer's loss, if any, from the disposition of a property, to the extent that it is
>
> (i) a superficial loss,
>
> . . .
>
> is nil.

[92] In 2002, the expression "superficial loss" was defined in section 54 as follows:

> "superficial loss" of a taxpayer means the taxpayer's loss from the disposition of a particular property where
>
> (*a*) during the period that begins 30 days before and ends 30 days after the disposition, the taxpayer or a person affiliated with the taxpayer acquires a property (in this definition referred to as the "substituted property") that is, or is identical to, the particular property, and
>
> (*b*) at the end of that period, the taxpayer or a person affiliated with the taxpayer owns or had a right to acquire the substituted property.

[93] Pursuant to subparagraph 40(2)(*g*)(i) and the definition of "superficial loss" in section 54, a taxpayer's loss on the disposition of property to any affiliated person is deemed to be nil.

[94] Subparagraph 40(2)(*g*)(i) did not apply to deny the loss on the disposition of the common shares of Rcongold to the PCT in 2002 because, at the time the transaction occurred, the PCT and the appellant were not included within the ambit of the definition of "affiliated persons" in section 251.1 as it then read.

[95] The definition of "affiliated persons" in section 251.1 was amended in 2005 to include paragraphs (*g*) and (*h*), which resulted in the inclusion of trusts within that definition. Paragraph (*g*) is relevant in this case and reads as follows:

> (1) Definition of "affiliated persons". For the purposes of this *Act*, "affiliated persons", or persons affiliated with each other, are
>
> . . .
>
> (*g*) a person and a trust, if the person
>
> (i) is a majority-interest beneficiary of the trust, or
> (ii) would, if this subsection were read without reference to this paragraph, be affiliated with a majority-interest beneficiary of the trust, . . .

[96] Subsection 251.1(1) now ensures that transactions between a trust and a person with whom it is "affiliated" will be subject to the stop-loss rules contained in the *Act*.

[97] In my opinion, the 2005 amendment to section 251.1 is a clear indication that the results achieved by the appellant were contrary to the object, spirit and purpose of the *Act* when read as a whole.

[98] The legislative history of sections 3, 38, 39 and 40 reveals that, from the inception of these provisions, the deduction of capital losses under paragraph 38(*b*) has been limited by anti-avoidance rules that refuse the recognition of artificial, superficial or undue losses. The interplay of these provisions with subparagraph 40(2)(*g*)(i), section 54, former subsection 55(1) and section 251.1 leads to the conclusion that the recognition of artificial capital losses realized within the same economic unit is contrary to the object, spirit and purpose of these provisions.

[99] A contextual and purposive interpretation of the provisions relied on by the appellant in seeking to obtain the tax benefit discloses that their object, spirit and purpose was to allow only the recognition of "true" capital losses sustained outside the economic unit.

[100] The transactions undertaken by the appellant amount to abusive tax avoidance because they defeat the underlying rationale of the capital loss provisions in the *Act*. Through the manipulation of the fiscal "amount" of the Rcongold common shares, the appellant created artificially devalued property that was transferred to a person within the same economic unit to create an artificial capital loss without incurring any real economic loss. On August 27, 2002, the appellant owned shares of Rcongold which had a fair market value of $8 million (the common shares). On August 28, 2002, the appellant continued to own shares of Rcongold which had a fair market value of $8 million (the Class "E" shares) and after the disposition of the common shares of Rcongold to the PCT, the appellant continued to own shares in Rcongold having a fair market value of $8 million.

[101] In *The Queen v. Landrus*, 2009 DTC 5085, 2009 FCA 113, the Federal Court of Appeal determined that the GAAR did not apply because a real economic loss resulted from the transactions under review and the underlying scheme of the *Act* allowed for the deduction of that real loss.

[102] The transactions undertaken by the appellant, however, clearly circumvent the application of specific anti-avoidance rules, which are, in this case, the stop-loss provisions. Subparagraph 40(2)(*g*)(i) and subsection 251.1(1) as it then read were circumvented by the appellant in 2002 in a manner that achieved an outcome that the provisions sought to prevent, namely, the creation of an artificial capital loss between parties with the same economic affiliations. The loss on the disposition of the common shares of Rcongold to the PCT established for the benefit of Mr. Cohen would now be deemed to be nil.

[103] In my opinion, the transactions forming part of the Reverse Freeze resulted in an abuse of the *Act* to which the GAAR should apply.

[104] For the foregoing reasons, I would dismiss this appeal with costs.

Signed at Ottawa, Canada, this 12th day of July 2011.

"Réal Favreau"

Favreau J.

CITATION:	2011 TCC 259
COURT FILE NO.:	2008-1667(IT)G
STYLE OF CAUSE:	Triad Gestco Ltd. v. Her Majesty the Queen
PLACE OF HEARING:	Montreal, Quebec
DATE OF HEARING:	April 23, 2010
REASONS FOR JUDGMENT BY:	The Honourable Justice Réal Favreau
DATE OF JUDGMENT:	July 12, 2011

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