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Copthorne and the GAAR

The Supreme Court of Canada has issued its latest ruling on the application of the General Anti-Avoidance Rule (the õGAARö). This decision—*Copthorne Holdings Ltd.* v. *Canada*ô is of interest not because it casts any new light on the GAAR but because it reminds us that we cannot lose sight of basic principles, no matter how complex the transactional mechanics may be.

ô But first, a few words of context. A shareholdersø share capital, as adjusted for tax purposes, is known as paid-up capital (õPUCö). Since PUC represents the amount of the taxpayerøs investment (as opposed to income earned by the corporation), PUC can always be distributed tax free. And, unlike some other jurisdictions, Canada does not require a corporationøs earnings to be distributed before PUC such that PUC can be distributed at any time.

Now, if a shareholder subscribes for shares in a corporation and that corporation uses the money to subscribe for shares in a subsidiary, the PUC of both the parent and the subsidiary will be increased by the amount of the single investment. This is a right result since each entity in the vertical chain is entitled to the tax-free return of its investment. However, if a subsidiaryøs PUC were added to its parentøs PUC upon an amalgamation, the amount that the shareholder could withdraw tax-free would be doubled; hence, a rule in the *Income Tax Act* (Canada) which cancels a subsidiaryøs PUC in this situation. This is to be distinguished from horizontal amalgamations upon which the PUC of sister corporations may be combined because they represent separate investments.

Added to this analysis is Canadaøs tax under Part XIII of the *Income Tax Act* on dividends, rents, royalties, interest and other forms of investment income distributed to non-residents. This tax applies at a rate of 25% subject to reduction or exemption under Canadaøs various tax treaties. Or, to the extent that the non-residentøs shares in the payor corporation have PUC, Part XIII tax can be avoided without recourse to any treatyô which brings us back to the *Copthorne* case.

Briefly stated, a Mr. Ka-Shing controlled one corporation with PUC in excess of $96 million and its subsidiary with PUC in excess of $67 million. Through a series of transactions involving related corporations in Canada, the Netherlands and Barbados, these two PUC accounts were positioned within sister corporations. The corporations were amalgamated and, because they were sister corporations rather than parent and subsidiary, their PUC was aggregated. In fundamental terms, tax-free share capital of $97 million was parlayed into tax-free share capital of $163 million. The shares were then redeemed on the basis that the distributions were wholly exempt from Canadaøs Part XIII tax.

Upon its review of these transactions, the Canada Revenue Agency (the õCRAö) applied the GAAR, disallowed the PUC increase and taxed the distribution accordingly. The Tax Court of Canada supported the CRA, as did the Federal Court of Appeal and, now, the Supreme Court of Canada.

The lesson to be drawn from *Copthorne* is to always hold in view the basic principles. Effective tax planning applies these principles, even manipulates them, but never tries only to hide them.

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Patrick Westaway is Tax Counsel to Sorbara, Schumacher, McCann LLP, a full service law firm based in Waterloo, Ontario. Patrick advises on a broad range of Canadian taxation issues such as corporate tax planning, structuring inbound investments, corporate reorganizations, cross-border financings, tax opinions for public disclosure documents, tax assessments, personal tax matters, wealth preservation, and on federal and provincial sales tax matters (HST/GST/PST). Patrick also practices corporate and commercial law with an emphasis on the implementation of matters related to his tax planning practice.

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