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Court Rules No Capital Loss Under GAAR Without Economic Loss

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Canada's Federal Court of Appeal (FCA) on October 15 issued its latest decision under the general antiavoidance rule in *Triad Gestco Ltd. v. The Queen*, 2012 FCA 258. The FCA denied the taxpayer's capital loss on the basis that it had suffered no economic loss.

Although the legislation does not expressly state that a taxpayer must suffer an economic loss, ''the capital gain system is generally understood to apply to real gains and real losses,'' the FCA said.

Background

Triad Gestco (TG) realized a capital gain of $8 million in its 2001 tax year on the sale of a commercial building, at arm's length, to a related party. It then completed transactions in its 2002 tax year to create an offsetting capital loss.

TG generated the capital loss by paying $8 million to acquire common shares in a new corporation. The common shares had an initial fair market value and adjusted cost base (ACB) to TG of $8 million. The new corporation then declared a stock dividend that it paid by issuing preferred shares with nominal paid-up capital but a redemption value of $8 million to TG. This shifted all the value of the new company from the common shares to the preferred shares. Because the shares had nominal paid-up capital, their ACB to TG was also nominal. Consequently, the taxpayer held common shares with an ACB of $8 million and nominal FMV, and preferred shares with a nominal ACB but an FMV of $8 million.

After the value of the common shares was reduced to a nominal amount, the taxpayer sold the common shares to a trust settled (by an unrelated person) for the benefit of the taxpayer's majority shareholder. Because the taxpayer's $8 million cost for the common shares exceeded the nominal sale proceeds received from the trust, a capital loss of $8 million was created in circumstances in which there was no economic loss. The taxpayer then sought to deduct the capital loss against the capital gain that it realized on the sale of the commercial building.

The Canada Revenue Agency applied the GAAR to deny TG's deduction of the capital loss on the basis that the company did not incur any economic loss.[1] The only issue before the FCA was whether the Tax Court of Canada (TCC) was correct to conclude that the relevant provisions had been abused.

TCC Decision and Taxpayer Submissions

The TCC concluded that an abuse occurred because the transactions were undertaken to ''defeat the underlying rationale of the capital loss provisions of the [Income Tax] Act,'' in part because ''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.''

The taxpayer argued that the TCC's conclusion was incorrect for several reasons:

- The presence of abuse must be determined based on the purpose of the specific tax provisions that give rise to the benefit, and the TCC failed to root its analysis in specific provisions.
- There is no general indication in the Income Tax Act that it allows for capital loss claims only if there is an ''economic loss''; in fact, several provisions deem a gain or loss to occur in the absence of an economic loss.
- The economic loss concept should be rejected in the circumstances. Although a 2005 amendment would have caused the trust to be ''affiliated'' with the taxpayer (with the result that the loss would be denied in the circumstances), the transactions at issue occurred prior to 2005.

FCA's Decision

The FCA concluded that the TCC's decision was correct, but for different reasons. The FCA did not accept the economic loss concept, noting that Parliament

[1]In order for GAAR to apply, there must be a tax benefit, an avoidance transaction, and an abuse of the specific tax provisions relied on by the taxpayer to achieve the tax benefit.

was aware that the concept of ''affiliated persons'' did not include trusts when the legislation was first enacted, and that when the definition was amended to add trusts in 2005, the amendment was not made retroactive.

The FCA agreed with the analysis of Justice Brent Paris in the companion case, *1207192 Ontario Limited v. The Queen*, 2011 TCC 283, *aff'd*, 2012 FCA 259.[2] The FCA agreed with Justice Paris's conclusion that the relevant ''provisions — particularly 38(b) — provide relief as an offset against capital gain when a taxpayer has suffered an *economic loss* on the disposition of property'' (emphasis added). The FCA referred to the specific provisions that allowed for a capital loss to be deducted, saying, ''[t]he result proposed by the appellant is fundamentally counter-intuitive as the capital gain system is generally understood to apply to real gains and real losses.''

In support of its position, the FCA pointed to the 1966 Carter Commission Report, which predated the introduction of the capital gain system, and to House of Lords jurisprudence that supported an interpretation of the capital gain provisions that included the concept of economic loss. After acknowledging that the legislation does not expressly include the phrase ''economic loss,'' the FCA read the concept of economic loss into the relevant provisions, including paragraph 38(b). ''Given their purpose — i.e. to tax the net realized increase in the value of capital assets — it is not possible, in my view, to read the provisions otherwise,'' the FCA observed.

Comparison of TCC Approaches

It is interesting to compare the TCC's abuse analyses in the *Triad Gestco* (2011 TCC 259) and *Ontario Limited* cases. Both cases involved similar facts and issues, and the taxpayer lost in both.

In *Triad Gestco*, however, Justice Réal Favreau concluded that the object, spirit, and purpose underlying the capital loss rules are to deny recognition of ''artificial capital losses realized within the same economic unit.'' He reached that conclusion relying in part on the stop loss rules in paragraph 40(2)(g), subsection 40(3.4). Those rules apply to deny or suspend capital losses created in transactions between ''affiliated persons.'' The definition of affiliated persons did not extend to trusts in 2002 (one of the years reassessed in *Triad Gestco*), but was amended to do so in 2005. It was commonly understood that the rules would have applied to the taxpayer in *Triad Gestco* if the 2005 amendments had been in force at that time. In effect, Justice Favreau regarded the 2005 amendments as fixing an oversight in the original stop loss rules.

Justice Paris respectfully rejected that reasoning in *Ontario Limited*. In his analysis, the various stop loss rules in the ITA did not indicate any general policy against losses realized between related parties, but rather ''were intended to deny losses in the limited and specific circumstances set out in those provisions.''

Justice Paris said the definition of affiliated persons as it read in 2002 ''sets out a carefully crafted group of relationships, and I believe that it is reasonable to infer that Parliament chose to limit the scope of the definition accordingly.'' In effect, he regarded the 2005 amendments as signifying a change in policy, not a repair of defective rules. Those rules did not extend to trusts in 2002, and therefore the GAAR should not apply to deny the taxpayer's capital loss realized in that year on a disposition to a trust merely because the same transaction would have been subject to the stop loss rules as subsequently amended, he said.

Justice Paris did, however, conclude that the rules allowing the deduction of capital losses were intended to apply only to real ''economic losses'' suffered by a taxpayer. In reaching this much more circumscribed conclusion, he relied in particular on comments in the Carter Commission Report; former subsection 55(1) (denying artificial or unduly created capital losses), which was repealed in 1988 in conjunction with the enactment of the GAAR; and the Department of Finance's technical notes, which accompanied the original introduction of the GAAR.

The FCA in *Triad Gestco* explicitly accepted the reasoning of Justice Paris over that of Justice Favreau — namely, that the GAAR applies because the taxpayer suffered only a ''paper loss'' without any real economic loss, and not because there is an overarching policy in the ITA that denies losses incurred within the same economic unit.

Of course, the result was the same to Triad Gestco: It lost. Unless overturned on appeal, the case remains a salutary reminder that the CRA must prove that any alleged abuse under the GAAR is firmly rooted in a proper textual, contextual, and purposive interpretation of the specific provisions relied on by the taxpayer to achieve the tax benefit in question, and that the GAAR should not be used as a sort of retroactive amendment tool.

Unfairness

Triad Gestco also argued on appeal that disallowing the capital gain would be unfair because it would realize a capital gain equal to the denied capital loss on its ultimate disposition of the preferred shares. The FCA gave that argument short shrift, however, noting simply that the taxpayer had not suggested any ''credible scenario'' in which the preferred shares would be sold. Had it done so, a court might have had some basis to

[2] In another case involving a similar issue, *Global Equity Fund Ltd. v. The Queen*, 2011 TCC 507, the taxpayer was successful at the TCC level. This decision was appealed to the FCA, but its decision has not been released.

adjust the consequences of the application of the GAAR as permitted under subsection 245(5). However, since no scenario was advanced, no further relief under that provision was granted.

Summary

This case provides authority that the Canadian system of taxing capital gains and losses, and paragraph 38(b) in particular, must be read with the understanding that ''economic loss'' is an unwritten aspect of the system that must be taken into account in tax planning. This is in contrast to the Supreme Court of Canada's seminal decision under the GAAR, *Canada Trustco Mortgage Co.*, 2005 SCC 54, in which the Court declined to read the concept of ''economic cost'' into the provisions allowing for a deduction of capital cost allowance.

Triad Gestco has until December 14 to apply for leave to appeal to the Supreme Court. At the time this article was written, it was not known whether Triad Gestco intends to seek that leave. ◆

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