FORM OR SUBSTANCE—WHERE ARE WE?

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The author provides an in-depth case analysis of the doctrine of "the substance" in taxation law, and such interrelated concepts as tax avoidance, sham transactions, the "business purpose" test and the intent, as opposed to motive, of a taxpayer. The author concludes that the "so-called" doctrine of "the substance" is inconsistent with the fundamental philosophical principles of our legal system and that the doctrine has not been accepted by the Courts as part of our law.

I. INTRODUCTION

In 1954 the Supreme Court of Canada in the case of *Dominion Taxicab Association* v. *M.N.R.*[1] espoused the proposition that ". . . in considering whether a particular transaction brings the parties within the terms of the Income Tax Act its substance rather than its form is to be regarded".[2] The Department of National Revenue, Taxation took the occasion of this decision as authority to revivify[3] the so-called doctrine of "the substance" for the purpose of combatting particular factual circumstances which offend it as a tax collecting body.[4]

The doctrine of "the substance" may be expressed as follows: If the purpose of a transaction is tax avoidance, the legal environment which a taxpayer creates for himself may be disregarded and another but less favourable legal environment, from the point of view of the taxpayer, may be substituted by the Minister of National Revenue for the purpose of assessing the taxpayer's liability for tax in respect of a particular transaction.[5] The legal environment being spoken of here is all those rights and obligations which our laws of property and civil rights recognize as emanating from particular relationships formed between persons for the very purpose of creating those rights and obligations. This is certainly not the same doctrine that the Supreme Court of Canada

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1. 54 D.T.C. 1020.
2. *Id.* at 1021, *per* Cartwright J., expressing the opinion of four of the five Supreme Court justices before whom the case was argued. This same proposition was approved of and applied by the majority decision of the Supreme Court of Canada in the case of *M.N.R.* v. *Atlantic Engine Rebuilders Ltd.*, 67 D.T.C. 5155, that decision, again, being expressed by Cartwright J.
3. The Minister of National Revenue was successful in having the Federal Court—Trial Division, in the case of *Massey-Ferguson Ltd.* v. *The Queen*, 74 D.T.C. 5329, give effect to the doctrine of "the substance". It is my respectful opinion that the reason the court gave effect to this so-called doctrine is that it misinterpreted these words espoused by the Supreme Court of Canada in the *Dominion Taxicab Association* case. *See* n. 1 and n. 2. Fortunately, on this point the Trial Division Court was reversed on appeal. *See* 77 D.T.C. 5013 *per* Urie J. at 5017.
4. The reference to the Department of National Revenue, Taxation, is in no way meant to be interpreted as a disparaging remark in respect of the administrative capabilities of its personnel; indeed, during my association with the head office of the Department, both during the time that I acted as one of its legal advisers and during the time that I worked in the Tax Policy Division of the Department of Finance, the officers working in the rulings, technical interpretations, tax avoidance and current amendments divisions of the Department impressed me with both their knowledge of the Income Tax Act and the common sense and equitable approach taken by them in the administration of the Act which has undergone substantial change since tax reform in 1972 in both form and substantive content.
5. The Federal Court—Trial Division, in the case of *Massey-Ferguson Ltd.* v. *The Queen*, 74 D.T.C. 5329, gave effect to such a proposition before being reversed on that point by the Federal Court of Appeal at 77 D.T.C. 5013 at 5017. *Supra* n. 3.

espoused in the *Dominion Taxicab Association* case.[6] The doctrine espoused in that case is well established in both the case law of England and Canada and it states that the nomenclature employed by the parties to an agreement to describe a transaction will not of itself be determinative of the rights and obligations with which each of the parties become invested or encumbered; rather, it is the intention of the parties to a transaction that will be determinative of such rights and obligations. Accordingly, if a court determines from the evidence adduced before it that the parties do not intend the rights and obligations which are inherent in a particular legal concept[7] to apply to them, the fact that the parties chose to describe the transaction by the name of that legal concept will be ignored and the rights and obligations flowing from the agreement entered into will be determined in accordance with what the parties intended.[8]

In a society such as ours, whose essential fabric has been woven together with the various legal concepts that have developed[9] over the passage of time, and whose continued existence depends upon the ability of its members to rely upon the certainty that those concepts bring to the order of their lives, surely such a doctrine as that of "the substance" is repugnant. Indeed, our social and cultural heritage has given us the sense of, and the right to enter into, legal relationships of our choice with the assurance that the rights and obligations which are inherent in those relationships will be enforced by the courts. It is my opinion that it is only in keeping with this philosophical background of our legal system that the provisions of a taxing statute, such as the Income Tax Act, be regarded as ancillary to the laws of property and civil rights. From this premise follow three necessary conclusions:

1. The particular rights and obligations that a taxpayer enjoys or is

6. *Supra* n. 1 and n. 2.

7. The very essence of our legal system is the recognition given by the courts to the various established relationships that may be created between persons in respect of their relationships with each other or to property of some form or another. Each of these relationships is perceived of as being the aggregate of all those rights and obligations that the courts through the development of judicial precedent, or the legislatures through statutory enactment, have attributed to it. These relationships are the embodiment of abstract notions or ideas which originate with the "law makers", be they the courts or legislative bodies, but which are in a continuous state of development through judicial interpretation. Such relationships are generically referred to as "legal concepts".

8. This same interpretation of that which was espoused by the Supreme Court of Canada in the *Dominion Taxicab Association* case was applied by the Exchequer Court of Canada in the case of *West Hill Redevelopment Co. Ltd.* v. *M.N.R.* 69 D.T.C. 5385. Indeed, at page 5392 of its decision that court said: "Coming now to consideration of the question of the character of the transaction or arrangements by which the payments in question were made, it is well settled that in considering whether a particular transaction brings a party within the terms of the Income Tax Act its substance rather than its form is to be regarded, and also that the intention with which a transaction is entered into is an important matter under the Act and the whole sum of the relevant circumstances must be taken into account. (*Dominion Taxicab Association* v. *Minister of National Revenue,* (1954) S.C.R. 82, 54 D.T.C. 1020; *Atlantic Sugar Refineries* v. *Minister of National Revenue,* (1949) S.C.R. 706, 49 D.T.C. 602.) Consequently I must endeavour as best I can to ascertain the real character and substance of the transaction or arrangements by which the payments in question were made and in so doing I must consider individually and collectively the agreements that were entered into and the surrounding circumstances and the course that was followed".

9. Until the last one hundred years or so, the "legal concepts" inherent in any of the provincial jurisdictions which adopted the English common law system of judicial precedent originated mainly from the English courts themselves, whether they exercised a common law or equitable jurisdiction; since that time, however, any new concepts which have been introduced into our legal system as a whole have originated with the legislatures of either the federal or provincial jurisdictions. In any case, no matter from where a concept originates, it undergoes continued development through the courts' interpretations of both earlier case precedent and statute law.

burdened with in respect of each legal relationship entered into with another are to be determined by the property and civil rights laws of the province having the legal jurisdiction over that relationship.

2. The totality of those legal relationships with their inherent rights and obligations constitutes the legal environment within which the provisions of the Income Tax Act are to be applied.
3. The application to a taxpayer of any provision of the Income Tax Act will depend upon whether or not the purview of that provision extends to and encompasses the legal environment that a taxpayer has created for himself.[10]

The conclusions to the above stated jurisprudential argument are so fundamental to the very being and continued existence of our legal system that I would have thought their truths to be axiomatic. To the contrary, the truths behind these conclusions have been challenged by the Minister of National Revenue on each occasion that he has argued, in one form or another, the concept[11] of the doctrine of "the substance". Because I find this concept so repugnant to what I perceive as one of the fundamental philosophies of our legal system,[12] I have difficulty in accepting the propriety of arguing such a concept before the courts, and would certainly question the credibility of any analysis of the relevant case law that concludes that this concept has been approved by our courts as a principle of law.

It has become apparent that on each occasion the concept behind the doctrine of "the substance" has been argued before the courts, it has been argued under the pretense of one of four different propositions:

1. In determining the substance of a transaction, its form is to be disregarded.
2. Where the motive for undertaking a transaction is the avoidance of tax, the transaction is a "sham" and accordingly the rights and obligations created thereby are to be disregarded.
3. Where a transaction or an expense in respect of a transaction lacks a "business purpose", the rights and obligations created by entering into the transaction are to be disregarded and any expense incurred in respect of the transaction loses its deductibility by virtue of being an undue or artificial reduction in income for purposes of the Income Tax Act.
4. The latter two (2) propositions have also been argued before our

10. This view is expressed by Mr. Justice Bastin in his dissenting judgment of the Federal Court of Appeal decision by *Kingsdale Securities Co. Ltd.* v. *M.N.R.*, 74 D.T.C. 6674 where he said at page 6692: "The validity of contracts and business transactions is governed by the law as to property and civil rights, which is a subject assigned to the provinces by our constitution. It follows that in administering the Income Tax Act the Minister of National Revenue must accept the legal position as it exists under provincial law. Adults enjoy wide powers to contract and, generally speaking, rights which they intend to create are inviolable in law subject to the condition that they do not defeat the rights of creditors or contravene a provincial statutory prohibition".
This view has also been expressed by the Federal Court—Trial Division in the case of *The Queen* v. *Lagueux & Freres Inc.*, 74 D.T.C. 6569 where, at page 6572 of its decision, Mr. Justice Decary said: "In my opinion fiscal law is an accessory system, which applies only to the effects produced by contracts. Once the nature of the contracts is determined by the civil law, the Income Tax Act comes into effect, but only then, to place fiscal consequences on those contracts. Without a contract, without a law and an obligation, there can be no fiscal levy. Application of the Income Tax Act is subject to a civil determination, whether such a determination be according to civil or common law".

11. *Supra* n. 1.

12. *Supra* n. 7 at 2.

courts as the complements of one another under the guise of yet a fourth proposition that, where the transaction lacks a "business purpose" it is a "sham" and accordingly the rights and obligations created thereby are to be disregarded.

Because of the interrelationship which each of these four propositions has with the other, the court decisions in the case analysis that follows have been looked at from the perspective of one or more of the following aspects: the tax avoidance motive of the taxpayer, the intention of the taxpayer in respect of the rights and obligations that he desired to be created by undertaking to effect a particular transaction, and the "business purpose" of a transaction or of an expense incurred in respect of a transaction. The observations drawn from this case analysis are supportive of the following conclusions of law:

1. The concept of the doctrine of "the substance" has been categorically denounced by our courts as a principle of law to be applied in revenue cases.
2. The only occasion on which our courts will disregard the rights and obligations that are purportedly created as a result of entering into a transaction is that where the transaction is found to be a "sham" because the manner of executing same is not consistent with an intent to create those rights and obligations.
3. A taxpayer's motive for undertaking a particular transaction is irrelevant for determining whether the transaction is a "sham".
4. There is no requirement in the Income Tax Act, other than that which is inherent in paragraph 18(1)(a) thereof,[13] that a transaction have a "business purpose".

II. THE DOCTRINE OF THE SUBSTANCE

There can be no doubt that the doctrine of "the substance" originated with the revenue authorities as a combatant to the tax avoidance methods of taxpayers. As a matter of logic, if the premise on which the doctrine of "the substance" is based lacks any validity in law, so must the doctrine itself. This premise, that to avoid tax is illegal, has been categorically rejected by both the English and Canadian courts as the following case analysis shows.

The classical statement on tax avoidance was originally uttered by Lord Tomlin in 1936 when the House of Lords decided the case of *Duke of Westminster* v. *Commissioners of Inland Revenue*.[14] There he said:[15, 16]

> . . . every man is entitled, if he can, to order his affairs so that the tax attracted under the appropriate Act is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland

13. That is, an expense incurred or an expenditure laid out is not deductible in calculating a taxpayer's income unless it was made or incurred by the taxpayer for the purpose of gaining or producing income from a business or property.
14. [1936] A.C. 1.
15. *Id* at 19.
16. This was not the first time that a taxpayer's right to avoid taxes within the framework of the law was approved by the English courts. Indeed, as early as 1926 Lord Sumner in the case of *Inland Revenue Commissioner* v. *Fisher's Executors* [1926] A.C. 395 said at page 412 of his decision: "My Lords, the highest authorities have always recognized that the subject is entitled to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law and that he may legitimately claim the advantages of any express term or of any omissions that he can find in his favour in the taxing acts. In so doing he neither comes under liability nor incurs blame".

> Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

These words of Lord Tomlin have been expressly approved of and applied by both the Exchequer Court and the Federal Court of Canada.[17] Moreover, the Supreme Court of Canada, as well as approving of this statement made by Lord Tomlin, has adopted a statement made by the Exchequer Court to the effect that, barring section 246, none of the provisions of the Income Tax Act can be interpreted as being a deterrent to tax avoidance.[18] More recently, both the Federal Court—Trial Division and the Federal Court of Appeal have expressed the tautological equivalent of Lord Tomlin's classical statement on tax avoidance. Indeed, in the case of *Alberta and Southern Gas Co. Ltd.* v. *Her Majesty the Queen,* Mr. Justice Cattanach in speaking of the tax avoidance motive of a taxpayer said:[19]

> It appears to me, in the circumstances of these particular appeals, so long as the transactions were not shams, that if the plaintiff by resort to express provisions in the Income Tax Act has succeeded in bringing itself precisely within the terms of those

17. The Exchequer Court of Canada in *Foreign Power Securities Corp. Ltd.* v. *M.N.R.*, 60 D.T.C. 5012 expressly approved of Lord Tomlin's classical statement on tax avoidance at page 5027 of its decision. The reasons given by Mr. Justice Noel in the Exchequer Court were expressly approved of by the Supreme Court of Canada at 67 D.T.C. 5084. Again the Exchequer Court in the decision of *Balstone Farms Ltd.* v. *M.N.R.*, 66 D.T.C. 5482, said at page 5490 of its decision as rendered by Mr. Justice Cattanach: "There is no impediment to a taxpayer so ordering his affairs as to escape or reduce tax but the substance of a transaction must be determined from the legal rights which flow therefrom ascertained upon ordinary legal principles"; *see Duke of Westminster's* case, [1936] A.C. 1. Mr. Justice Cattanach of the Federal Court—Trial Division expressly adopted Lord Tomlin's classical statement on tax avoidance at page 6015 of the decision of that court in the case of *The Queen* v. *Esskay Farms Ltd.*, 76 D.T.C. 6010.

18. At 67 D.T.C. 5084, the Supreme Court of Canada expressly adopted, as its own, the reasons given by the Exchequer Court in the case of *Foreign Power Securities Corp. Ltd.* v. *M.N.R.*, 66 D.T.C. 5012. At page 5027 of the decision of the Exchequer Court Noel J. said: "There is indeed no provision in the Income Tax Act which provides that, where it appears that the main purpose or one of the main purposes for which any transaction or transactions was or were effected was the avoidance or reduction of liability to income tax, the court may, if it thinks fit, direct that such adjustments shall be made as respects liability to income tax as it considers appropriate so as to counteract the avoidance or reduction of liability to income tax which would otherwise be effected by the transaction or transactions. The only authority of this character conferred by the statute is conferred on Treasury Board by section 138". Sections 138 and 138A are the equivalent of sections 246 and 247 in the post 1971 Income Tax Act. Since tax reform in 1972, two additional tax avoidance provisions have been expressly added to the provisions of the Income Tax Act, namely subsections 95(6) and 103(1).

19. 76 D.T.C. 6362 at 6369 to 6370. Chief Justice Jackett in giving the decision of the Federal Court of Appeal reported as 77 D.T.C. 5244, affirmed this view of the Trial Division; however, the decision of the Court of Appeal is not couched in language which is as all-encompassing as that of both the trial judge in this case and the Federal Court of Appeal in the case of *Produits L.D.G. Products Inc.* v. *The Queen*, 76 D.T.C. 6344. Rather, the Chief Justice preferred to limit his comments to those provisions of the Income Tax Act which may be characterized as "incentive provisions". Accordingly, to paraphrase what was said at pages 5248 to 5249 of his decision, where a taxpayer brings himself within the "four corners" of an "incentive provision" of the Income Tax Act, notwithstanding that his motivation in doing so is to reduce taxes otherwise payable, subsection 245(1) of the Income Tax Act does not have application to deny, in calculating the taxpayer's income, the deduction of an expenditure laid out by the taxpayer for the purpose of bringing himself within that "incentive provision". In this regard Chief Justice Jackett said: "The provisions for deductions and taxation of capital amounts seem to me to have the obvious purpose of encouraging taxpayers to put money into such resource properties and keep it there. That being what the provisions seem to have been intended to encourage, as it seems to me, a transaction that clearly falls within the object and spirit of section 66 cannot be said to unduly or artificially reduce income merely because the taxpayer was influenced in deciding to enter into it by tax considerations". The Supreme Court of Canada at 78 D.T.C. 6566 dismissed, without written reasons, the appeal to the decision of the Federal Court of Appeal. Thus, it would appear that the Supreme Court of Canada has approved of the proposition, in its limited application to incentive legislation, that, the provisions of the Income Tax Act cannot be interpreted in a manner that gives them a tax avoidance purpose.

> provisions regardless of the motivation which inspired the taxpayer to resort thereto, that motive admittedly being the reduction of tax, and in these appeals the reduction was to nil, or complete avoidance, that that concludes the matter and the motivation is irrelevant.

And, in the case of *Produits L.D.G. Produits Inc.* v. *The Queen* the Federal Court of Appeal in speaking of the tax avoidance motive of a taxpayer said:[20]

> There is nothing reprehensible in seeking to take advantage of a benefit allowed by the law. If the taxpayer has made an expenditure which, according to the Act, he may deduct when calculating his income, I do not see how the reason which prompted him to act can in itself make this expenditure non-deductible.

The concept behind, and hence the validity of, the doctrine of "the substance" is definitely rejected by the decisions of these cases. Moreover, these cases support the proposition that in Canada one may arrange his affairs in such a manner as to be liable for the least amount of tax payable under the provisions of the Income Tax Act and cannot be required to pay the tax that otherwise would have been payable had his affairs not been so arranged. One need not rely, however, on the logistical argument that, if the premise, on which a proposition is based, falls, so must the proposition itself, as the only authority for the conclusion that the doctrine of "the substance" is not a principle of Canadian law. There is indeed more cogent authority in the case law for that conclusion.

The so-called doctrine of "the substance" was expressly laid to rest in England as long ago as 1936 when the House of Lords decided the *Duke of Westminster* case.[21] In this regard the words of Lord Tomlin are expressive of the opinion of all the Law Lords who heard the case:[22]

> . . . it is said that in revenue cases there is a doctrine that the court may ignore the legal position and regard what is called "the substance of the matter", . . . This supposed doctrine (upon which the Commissioners apparently acted) seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned. . . . This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.

Lord Russel of Killowen in that same decision was somewhat more specific in respect of what the House of Lords rejected as a proposition of law when the doctrine of "the substance" was denounced by that court. Indeed, he said:[23, 24]

> If all that is meant by the doctrine is that having once ascertained the legal rights of the parties you may disregard mere nomenclature and decide the question of taxability or

20. 76 D.T.C. 6344, *per* Pratte J. at 6349.
21. *Supra* n. 14.
22. *Id* at 19-20.
23. *Id.* at 25.
24. In the case of *Wesleyan and General Assurance Society* 30 T.C. 11, at the House of Lords level, 30 T.C. 24, Viscount Simon, in referring to the doctrine of "the substance", adopted the words of Lord Green in the English Court of Appeal decision of that same case and said at page 25 of his decision: "There have been cases in the past where what has been called the substance of the transaction has been thought to enable the court to construe a document in such a way as to attract tax. That particular doctrine of the substance as distinct from form was, I hope, finally exploded by the decision of the House of Lords in the case of *Duke of Westminster* v. *Commissioners of Inland Revenue,* 19 T.C. 490". Lord Green, at the Court of Appeal level of that same case, in speaking of the doctrine of the substance said at page 16 of his decision that: "The doctrine means no more than that the language that the parties use is not necessarily to be adopted as conclusive proof of what the legal relationship is".

> non-taxability in accordance with legal rights, well and good. . . . If, on the other hand, the doctrine means that you may brush aside deeds, disregard the legal rights and liabilities arising under a contract between parties, and decide the question of taxability or non-taxability upon the footing of the rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such a doctrine.

The *Duke of Westminster* case was applied in Canada as early as 1939 when the Judicial Committee of the Privy Council decided the case of *Pioneer Laundry & Dry Cleaners* v. *M.N.R.*.[25] Again in 1946, Mr. Justice Kellock in the Supreme Court of Canada decision of *Dominion Telegraph Securities Ltd.* v. *M.N.R.*[26] expressly rejected the doctrine of "the substance": "While surrounding circumstances may be regarded for the purpose of construing an instrument, the true legal position arising upon the instrument so construed may not be ignored in favour of the supposed substance". More recently, the Federal Court of Canada has on two occasions expressly rejected the doctrine of "the substance". In its decision in the case of *Alberta and Southern Gas Co. Ltd.* v. *Her Majesty The Queen* the Trial Division of that court adopted the words of Lord Tomlin in the *Duke of Westminster* case: "This so-called doctrine of 'the substance' seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of the tax sought from him is not legally claimable".[27] Again, in the case of *The Queen* v. *Esskay Farms* Mr. Justice Cattanach, speaking foe that same court, said: "*The Commissioners of Inland Revenue* v. *Duke of Westminster* is also authority for the proposition that 'the substance' of a transaction must be determined from the legal rights which flow therefrom ascertained upon ordinary legal principles".[28, 29]

There is little evidence in the reported Canadian cases that the doctrine of "the substance" has been argued before the courts as such in the wake of the *Duke of Westminster* and *Pioneer Laundry & Dry Cleaning* cases.[30] However, this doctrine has been argued under the guise of yet other propositions which, ironically enough, have arisen from these very case decisions which rejected it originally. Indeed, in those cases statements were made by the House of Lords[31] and the Judicial Committee of the Privy Council[32] respectively, which provided the Minister of National Revenue with the very "key" to bring back before our courts via the back door, the doctrine of "the substance". In the *Duke*

25. (1939) 1 D.T.C. 499. The Judicial Committee of the Privy Council adopted as its own the reasons given by Davis J. in his dissenting judgment of the Supreme Court of Canada cited as (1939) 1 D.T.C. 499. At page 499-3 of his decision, Davis J. expressly adopted the above quoted words of Lord Tomlin in the *Duke of Westminster* case.

26. (1946) 2 D.T.C. 875 at 878. It should be noted that while the decisions of all the Supreme Court Justices were unanimous, none of the other judgments referred to the *Duke of Westminster* case.

27. 76 D.T.C. 6362 at 6370.

28. 76 D.T.C. 6010 at 6015.

29. The Exchequer Court of Canada in its decision in the case of *Balstone Farms Ltd.* v. *M.N.R.* 66 D.T.C. 5482 at 5490, also attributed the *Duke of Westminster* case as being authority for this proposition.

30. However, it would seem from the reasons for judgment given by Mr. Justice Heald in the Federal Court—Trial Division decision of *Massey-Ferguson Ltd.* v. *The Queen*, 74 D.T.C. 6529 at 6533 that the words of the Supreme Court of Canada in the *Dominion Taxicab Association* case, *supra* n. 1, were argued and were accepted by Mr. Justice Heald as being authority for the proposition that the so-called doctrine of "the substance" is a principle of Canadian law. Fortunately, the Court of Appeal overruled this decision on this very point. *See* 77 D.T.C. 5013.

31. *Duke of Westminster* v. *Commissioners of Inland Revenue*, [1936] A.C. 1.

32. *Pioneer Laundry & Dry Cleaning* v. *M.N.R.*, (1939) 1 D.T.C. 499-69.

of Westminster case these statements are to be found in the judgments of Lord Tomlin and Lord Russell of Killowen, respectively, as follows:

> There may of course, be cases where documents are not bona fide nor intended to be acted upon, but are only used as a cloak to conceal a different transaction. No such case is made or even suggested here. The deeds of covenant are admittedly bona fide and have been given their proper legal operation. They cannot be ignored or treated as operating in some different way because as a result less duty is payable than would have been the case if some other arrangement (called for the purpose of the appellants' argument 'the substance') had been made.[33]
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> It is conceded that the deeds are genuine deeds, i.e., that they were intended to create and do create a legal liability on the Duke to pay in weekly payments the annual sum specified in each deed, whether or not any service is being rendered to the Duke by the covenantee. Further, it is conceded that the sums specified in the deeds were paid to the covenantees under the deeds.[34]

In the *Pioneer Laundry* case this statement is to be found in the decision of the Committee given by Lord Thankerton:[35]

> Their Lordships agree with the Chief Justice and Davis J. that the reason given for the decision was not a proper ground for the exercise of the Minister's discretion, and that he was not entitled, in the absence of fraud or improper conduct, to disregard the separate legal existence of the appellant company and to inquire as to who its shareholders were and its relation to its predecessors. The taxpayer is the company, and not its shareholders.

III. THE DOCTRINE OF THE SHAM AND THE BUSINESS PURPOSE OF A TRANSACTION

There can be no doubt that words paraphrastic of the above quotations have been argued before our courts by the Minister of National Revenue in an effort to establish as a principle of law that where the motive of a taxpayer for entering into a transaction is the avoidance of tax the legal rights and obligations which are seemingly created thereby are not representative of the true "intent" of the taxpayer and accordingly are to be disregarded for purposes of assessing the taxpayer's liability under the Income Tax Act. The first case where evidence of such an argument appears is that of the Exchequer Court decision in the case of *Shulman* v. *M.N.R.*[36] It is apparent from the reasons given by the court that the Minister's argument did not meet with success in that case. Indeed, Mr. Justice Ritchie after referring to both the *Duke of Westminster* case and the *Pioneer Laundry* case, said[37] that unless he found fraud or improper conduct he could not disregard the separate legal existence of the management company which the taxpayer intended to incorporate and

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33. *Supra* n. 14, *per* Lord Tomlin at 21.
34. *Id. per* Lord Russell of Killowen at 21. Lord Wright also expressed this same idea where he said at page 29 of his judgment:
    > If the case were one in which it was found as a fact in regard to each of the deeds in question that it was never intended to operate as a legal document between the parties, but as concocted to cover up the payment of salary or wages and to make these payments masquerade as annuities in order to evade surtax, it may well be that the court would brush aside the semblance and hold that the payments are not what they seemed.
35. *Supra* n. 25, *per* Lord Thankerton at 499-72. These words of Lord Thankerton have subsequently been expressly applied by the Exchequer Court in two of its decisions, both of which were affirmed by the Supreme Court of Canada: *Shulman* v. *M.N.R.*, 61 D.T.C. 1213 at 1219, affirmed without written reasons by the Supreme Court of Canada at 62 D.T.C. 1166; and *Foreign Power Securities Corp. Ltd.* v. *M.N.R.*, 66 D.T.C. 5012 at 5014, affirmed at 67 D.T.C. 5084 by the Supreme Court of Canada by expressly adopting as its own, the reasons of the Exchequer Court.
36. 61 D.T.C. 1213 (Exchequer Court) affirmed without written reasons by the Supreme Court of Canada at 62 D.T.C. 1166.
37. *Id.* at 1219.

did in fact incorporate. The learned judge concluded, however, that the taxpayer never intended to perform as agent of the management company, the non-legal administrative duties of the law firm of which the taxpayer was a member. Indeed, had such been the true intent of the taxpayer, the management company would have at least been made to be seen by the non-legal personnel employed by the law firm; moreover, the management company would have retained a portion of the management fee that it purportedly received from the law firm, and it would have paid a reasonable portion of that fee to the taxpayer as salary. None of these indicia which the court considered to be "normal" for a true management company arrangement, were found to exist in the circumstances of this case.[38] It would appear that the rationale used by the court in coming to its decision in light of the case authorities relied on[39] is that the manner of implementing the purported management company agreement was so unnatural (that is, it was so contrary to the normal manner by which management company arrangements are implemented), that, objectively, it could not have been the intention of the taxpayer that he perform the non-legal duties of the law firm as agent (employee) of the management company. Accordingly, the management agreement between the management company and the law firm was disregarded because it did not represent the true legal relationship that the taxpayer intended to create between the law firm and the management company; and the taxpayer was assessed for income tax on the basis that there did not exist a management agreement between the law firm and the management company. Thus the court decided that neither an agency agreement (e.g., employment agreement) creating rights and obligations between the management company and the taxpayer, nor an agreement for services creating rights and obligations between the law firm and the management company, ever came into being and accordingly the taxpayer as a partner of the law firm could not be assessed for tax as if such a legal environment existed.[40] The important thing to be gleaned from this decision is that the taxpayer's motive for choosing the manner for effecting the non-legal duties of the law firm was not the *sine qua non* of

38. Rather, the management fee was "paid" and "received" by mere book entries; indeed, the amount of the fee was debited to the payable account of the law firm as one entry, and simultaneously that same amount was made a credit entry on the law firm's books as a working capital loan. What was even more incredulous was that the working capital loan was attributed as being made by taxpayer himself who purportedly funded it with the amount of the management fee that he "received" tax free; indeed, the scenario set up by the taxpayer enabled him to "receive" the management fee as the repayment of a loan owed to him by the management company. The law firm never lost the "use" of the amount of the management fee for an instant which purportedly "moved" from the "possession" of the law firm to the "possession" of the management company which in turn "paid" that same amount, as a repayment of a debt, to the taxpayer who in turn "loaned" that same amount back to the law firm.

39. *Duke of Westminster* case [1936] A.C. 1; *Pioneer Laundry & Dry Cleaning Ltd.* v. *M.N.R.*, (1939) 1 D.T.C. 499-69; *Saloman* v. *Saloman* [1897] A.C. 22 (H. of L.).

40. It should be noted that the court did not choose to express its reasons in the same manner that I have expressed them above. Rather the court chose to "couch" its reasons in the language of subsection 137(1) of the pre-1972 Act. That is, the court held at page 1221 of its decision that the manner in which the purported management agreement was implemented as between the law firm and the management company (i.e., the fact that an amount was never retained by the management company as a fee on the one hand, and that an amount in respect of the management company fee never reduced the working capital of the law firm on the other hand) and as between the management company and the taxpayer (i.e., the fact that the taxpayer did not receive a salary for his services as an agent of the management company) was so unnatural that to allow the law firm to deduct from its income a fee for management services which were never intended to be performed and which were never performed, would amount to an "artificial" reduction in income.

the court's finding that the true intent of the taxpayer was not to create those rights and obligations indicative of a true management company arrangement. Indeed, the Exchequer Court did not decide that the taxpayer's motive of tax avoidance was relevant for determining whether his true intent was to create a management company arrangement; rather the court only concluded that the taxpayer's motive of tax avoidance was consistent with its independent finding of fact that the taxpayer did not intend to create the legal relationships indicative of a management company arrangement.[41]

The next reported case wherein the argument was made by the Minister of National Revenue that the acts done and the documentation evidencing a transaction did not represent the taxpayer's true "intent", and thus could be ignored for the purpose of assessing his liability under the Income Tax Act, is that of *Susan Hoisery Ltd. (No. 2)* v. *M.N.R.*.[42] Here the argument of the Minister met with success. The authorities on which the Exchequer Court relied were two: The statements[43] made by Lord Tomlin and Lord Russell of Killowen in the *Duke of Westminster* case, and the decision of Lord Justice Diplock in the English Court of Appeal decision of *Snook* v. *London West Riding Investments Ltd.*.[44] In this latter case the doctrine of the "sham" was espoused. This doctrine expresses the same essential concept that Lord Tomlin and Lord Russell of Killowen espoused, but its purview is of seemingly greater scope in that it makes express reference to both the acts done and the documentation executed in respect of a transaction, whereas Lord Tomlin and Lord Russell of Killowen limited their statements to the documentation of a transaction. The doctrine of the "sham" has become of such importance in revenue cases that it is worthwhile quoting the words of its creator, Lord Justice Diplock:[45]

> As regards the contention of the plaintiff that the transactions between himself . . . and the defendants were a 'sham', it is I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. One thing I think, however, is clear in legal principle, morality and the authorities . . . that for acts or documents to be a 'sham', with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a 'shammer' affect the rights of a party whom he deceived. . . .

41. That is, it is my opinion that having once decided that the manner of the taxpayer's conduct was not "normal" for there to be in existence either an "agency" relationship between the management company and the taxpayer or a "service contract" between the law firm and the management company, the court determined that the taxpayer never intended to create the legal relationships indicative of a management company carrying on the non-legal duties of a law firm. Only after such determination did the court refer to the taxpayer's motive as being consistent with the fact that such legal relationships were never created. The court did not conclude that a taxpayer's motive of tax avoidance would necessarily preclude a valid management company arrangement from ever being set up.

42. 69 D.T.C. 5346 (Exchequer Court).

43. These words which are quoted above at pages 242-243 expressed the proposition that the legal documentation evidencing an arrangement entered into by a taxpayer could only be disregarded in those circumstances where the rights and obligations purported to be created by that documentation were not representative of the true legal relationship that parties to the arrangement intended would govern the relations between them.

44. (1967) 1 All E.R. 518.

45. *Id.* at 528.

After finding as a fact that neither the taxpayer, nor those others who played a role in the scenario which was transacted to make it appear that an employee's superannuation or pension fund or plan had been implemented for the benefit of the taxpayer's employees, intended to create the legal rights and obligations which would ordinarily have resulted from the establishment of such a plan, Mr. Justice Gibson applied the doctrine of the "sham" for the purpose of disregarding both the documentation and the acts done in respect of the plan for the purpose of giving it the appearance of being bona fide. Once such evidence was stripped away from the circumstances that the court found to be relevant for determining the true legal environment that the taxpayer created for itself, the court held that a superannuation or pension plan never come into existence and disallowed the deduction claimed as a contribution to such a plan. The important aspect of this case is that the Exchequer Court determined the transaction, i.e., the purported setting up of the pension plan, to be a "sham" independently of what it determined the taxpayer's motive to be in purporting to establish such a plan. Indeed, the court determined the transaction to be a "sham" from an objective consideration of the "acts done" by both the taxpayer and other parties in giving effect to the transaction.[46]

In the same year that the Exchequer Court decided the *Susan Hosiery* case, *West Hill Redevelopment Company Limited* v. *M.N.R.*[47] was argued before that same court. There, without expressly referring to either the *Susan Hosiery* case or the *Snook* case,[48] the Exchequer Court applied the doctrine of the "sham" and decided that the payments made by the taxpayer in respect of a pension plan found to be a "sham" were themselves "shams" and accordingly, were to be disregarded in determining the taxpayer's income for purposes of the Income Tax Act.[49] The court concluded that a true pension plan was not established, not because the taxpayer's motive in setting up a plan was to avoid the payment of tax, but because the taxpayer never intended to establish and

46. The court was impressed by the fact that the pension plan was contemporaneously funded and collapsed; indeed, no sooner had the taxpayer paid an amount into the plan than it was paid out as a benefit to the purported beneficiary of the plan. At page 5353 of his decision Mr. Justice Gibson said: ". . . The purported Employees' Pension Plan of the appellant, was treated by all parties to it . . . as a mere simulate. It masqueraded as an employees' pension plan but was nothing of the sort. The directions to pay in and to pay out contemporaneously given to the Canada Trust Company . . . resulting in the round-robin of cheques . . . never established a pension plan, nor any relationship of trustee, *cestui que trust*, nor any other legal or equitable rights or obligations in any of the parties and none of the parties intended at any material time that there should be any".

47. 69 D.T.C. 5385. This case has already been discussed above in respect of the Exchequer Court's interpretation and application of the proposition espoused by the Supreme Court of Canada in the *Dominion Taxicab Association* case. *Supra* n. 8.

48. *Supra* n. 44.

49. At page 5393 of its decision the court said: "It is my conviction that the plans were . . . simulates used as a cloak to disguise the payments in question and make them appear to be what they really were not, namely, payments into a pension plan which would qualify for deduction in computing the appellant's income for income tax purposes. In my view, also, the payments, if allowed to be deducted, would artificially reduce the appellant's income; and section 137 prohibits their deduction". It is interesting to note that the court decided that because the payments in question were "shams" they were not deductible under a provision of the Income Tax Act which required a payment to have a true character as a payment into a pension fund; and it was only as an ancillary reason for disallowing their deduction that the court referred to subsection 137(1) as disallowing the deduction of artificial expenditures. The inference from the decision is that the expenditures in question were artificial only because herein they were shams; accordingly in light of this inference, subsection 137(1) does not have a purview or an application for purposes of disallowing a deduction in calculating income that is any greater than the doctrine of "the sham", that is, the invocation of subsection 137(1) depends upon the prior finding of a sham.

did not establish a true pension plan.[50] Again, the true intention of the taxpayer was determined from the court's objective interpretation of the conduct of the parties to the transaction.[51]

Another interesting aspect of this case is that its report contains evidence of the argument having been made by the Minister of National Revenue that a transaction is a "sham" if it does not have a "legitimate business purpose". Unfortunately the report does not make mention of what the Minister meant by a "legitimate business purpose"; however, in answer to this proposition put forward by the Minister, the Exchequer Court said that if the transaction is not a sham it will have a legitimate business purpose.[52] Because the court's response is so obscure, one can only speculate on the inference to be drawn therefrom. However, it would appear that the court espoused the proposition that, if the inherent nature of a transaction is business related such will necessarily be given expression if the transaction is consummated and it is not a "sham". Moreover, whether a transaction has such an inherent business nature is not determined from, nor is it manifested in, the motive of the taxpayer for entering into the transaction; rather, the business nature of a transaction, if it has one, is manifested in the rights and obligations which are created by the parties to a transaction in giving legal effect to same. If this proposition were broken up into its constituent elements the following principles would follow: (1) A transaction by virtue of its very nature may or may not have a business purpose. (2) A business purpose has for its objective the achievement of some business goal, as for instance, the continuity of a work force by providing a pension fund for those employees who do not leave their employment until retirement.

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50. In this respect the court said at page 5394 of its decision: "The scheme was ingenious and was pursued step by step, but the steps add up to one large stride intended, in my opinion, not really to provide pensions but predominately to achieve for the company a substantial deduction from income. While a taxpayer may arrange his affairs so as to legitimately obtain a deduction from income, he is not entitled to if he does not clearly bring his claim for deduction within the terms of the provision conferring the right of deduction from what would otherwise be taxable income. (*Sheaffer Pen Co.* v. *Minister of National Revenue*, (1953) Ex. C.R. 251, 53 D.T.C. 1223. If a claim for deduction of payments into a pension plan is to succeed the plan must be a true pension plan and not a plan which masquerades as a true pension plan but is not one".

51. Indeed, at page 5393 of its decision the court said in giving its reasons for judgment that ". . . the Pension Plan, the Deferred Profit Sharing Plan and the Trust Agreements, taken at their face value, purport to create legal rights and obligations and to establish a pension plan and a deferred profit sharing plan. But, considering them in all the circumstances *and in the course that was followed*, it is my conviction that the appellant did not intend to establish and did not establish real and true plans of that character. There was no intention that the plan would operate long enough to make annuity or periodical payments. It was in fact terminated and its funds were disbursed within a short time after it was established and where eventually the money was put back into the revived Plan it was immediately taken from it and returned to the company rather than left in the Plan or invested by the Plan for the purpose of paying pensions". (The italics are mine.) Again at page 5394 of its decision the court said: In my view *the course that was followed* was devious and unnatural and not in accordance with normal business practice. I think that in retrospect *it* (*i.e., the course that was followed*) shows that what was intended was to provide the brothers with a retirement insurance policy . . . and to obtain an income deduction of nearly $200,000 for the company, without involving *any real payment out* by it, except for the sum paid to the insurance company. The various payments were accomplished by practically simultaneous exchange of cheques. The cheques from the company to the Pension Plan were matched by a cheque for a like amount back to the company, which in effect made no deduction in the company's funds". (The italics are mine.)

52. In this regard the court said at page 5393 of its decision that: "It is not disputed that there *can* be a sufficient business reason for the establishment of a superannuation or pension plan for employees and that such a plan *can* have a legitimate business purpose. But the respondent disputes that in the present instance there was such a reason or legitimate business purpose. *The answer depends largely on whether there was a true pension plan".* (The italics are mine.)

(3) The business purpose of a transaction is not dependent upon nor is it affected by the motive of the taxpayer for entering into the transaction; indeed, whereas the effect of a transaction may be the achievement of some business objective, the sole reason or motive of the taxpayer for achieving that business objective may well be the incentive of a tax write-off. (4) If a transaction has a business purpose it will of necessity be manifested in the rights and obligations created in giving the transaction its legal effect. (5) However, if a transaction is a sham because the parties thereto do not intend to create the rights and obligations ordinarily created when a transaction of a given nature is consummated, the inherent business nature or purpose of the transaction, if it has one, likewise will not be effected. In such a case it is not because the nature of a transaction lacks any business purpose that the transaction is a sham; rather, it is because the transaction is a sham that it lacks the achievement of a business purpose, assuming the inherent nature of the transaction is the achievement of such a purpose.

Subsequent to the decision of the *Susan Hoisery*[53] and the *West Hill Redevelopment Co.*[54] cases, the Exchequer Court of Canada in *Cattermole-Tretheway Contractors Ltd.* v. *M.N.R.*[55] was called upon to decide whether a deduction claimed by the taxpayer for the purpose of calculating its income would run afoul of subsection 137(1)[56] of the Income Tax Act because such a deduction would artificially reduce the taxpayer's income.[57] The court relied on the authority of its two previous decisions[58] and, upon finding[59] that the parties to the transaction never intended that any legal obligations were to be created nor that the documentation of the transaction would ever be acted on, held that the transaction was a sham and accordingly so was any expenditure purportedly made in respect of same.[60, 61] Again, it is important to note that the court did not determine the taxpayer's true intention, in respect

53. *Supra* n. 42.

54. *Supra* n. 47.

55. 71 D.T.C. 5010.

56. Subsection 137(1) of the pre-1972 Income Tax Act is the equivalent of subsection 245(1) of the post-1972 Income Tax Act.

57. You will recall that this same issue was decided by the Exchequer Court in the *Shulman* case discussed above. The applicability of subsection 137(1) was also argued as an alternative submission in the *West Hill Redevelopment* case, *supra* n. 11 and n. 12.

58. *Susan Hosiery Ltd.* v. *The Minister of National Revenue*, 69 D.T.C. 5346; *Shulman* v. *The Minister of National Revenue*, 61 D.T.C. 1213.

59. At pages 5014 to 5015 of its decision the court found as a fact that any "expenditure" made by the taxpayer in respect of funding the pension plan purportedly set up for the benefit of the taxpayer's employees was immediately received back by the company as a "loan". This "round-robin" of payments and receipts is not unlike the scenario of the *Susan Hosiery* case. Moreover, the court found here that the alleged plan was binding upon no one except the trustee and upon the trustee only in respect of the amount of the fund actually paid to the trustee.

60. This is what the Exchequer meant when it said at page 5014 of its decision in the *Cattermole-Trethewey Contractors* case that "any artificiality may taint an expenditure". In other words if any part of the transaction in respect of which an expenditure is purportedly made is found to be artificial, i.e., to be a sham, then any expenditures made in respect of that part of the transaction must also be "artificial", i.e., be a sham. Such an observation is consistent with the doctrine of the "sham" as espoused in the *Snook* case, *supra*, when Lord Justice Diplock said therein that the acts done (which would include an expenditure made) and the documentation in respect of a sham transaction may be ignored for determining the true legal relationship, if any, created by the parties to the sham transaction.

61. This interpretation of the decision is borne out by the Federal Court—Trial Division decision of *Simard-Beaudry Inc.* v. *M.N.R.*, 74 D.T.C. 6552 where the court said at page 6556 of its decision: "A transaction or a financial operation constitutes a sham when it is not truly what it appears to be or when it is but a veil to dissimulate an entirely different state of affairs. For example, when one uses the pretext of establishing a pension plan for employees of a firm for

of the rights and obligations to be created by the impugned transaction, from evidence of its motive for entering into the transaction; rather, the court determined that the taxpayer never intended to create any legal rights and obligations by looking objectively to the conduct of the parties to the transaction.[62]

The Supreme Court of Canada in the case of *M.N.R.* v. *Cameron*[63] approved of and applied the doctrine of the "sham" as espoused by Lord Justice Diplock in the *Snook* case.[64] Here, the Supreme Court of Canada rejected the argument of the Minister of National Revenue that the scenario transacted was a sham—a management company was incorporated to carry on, through its employees for the benefit of another corporation, the duties which those same employees formerly carried on as employees of that other corporation. In coming to its conclusion that the transaction was not a sham because the legal rights and obligations which the management agreement purported to create were exactly those which the parties intended, the court looked to the acts done by the parties in pursuance of the agreement.[65] Four conclusions or observations can be drawn from this decision of the Supreme Court of Canada: The first is that the doctrine of the sham attained the status of a principle of law to be followed by all Canadian courts. Second, in determining whether a transaction and anything done in connection therewith is a sham, the only relevant consideration is whether the true intention of the taxpayer was to create the rights and obligations which the transaction gave the appearance of creating. Third, in deciding that the true intent of the taxpayer was to create the rights and obligations the transaction gave the appearance of creating and hence that the transaction was not a sham, in the context of circumstances that clearly showed the taxpayer's motive for entering into the transaction was tax avoidance, the necessary inference of the decision is that a taxpayer's motive is not relevant for considering whether or not the transaction and any acts done[66] in respect

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the purpose of furnishing a means of removing profit from that firm free of tax, without having the true intention of furnishing protection to employees or to continue to make disbursements to the pension plan. *See Cattermile-Trethewey Contractors Ltd.* v. *M.N.R.* 71 D.T.C. 5010".

62. It should be noted that Sheppard D.J. seems to interpret the earlier Exchequer Court decision of the *Shulman* case as espousing the proposition that where the primary motive of a taxpayer is the avoidance of taxes, that motive will of itself make any expenditure in respect of a transaction "artificial", thereby making subsection 137(1) applicable so as to prevent its deduction in calculating income. In my opinion this is not what the Exchequer Court said but rather the perspective in which that comment should be put is indicated at pages 244 to 245 above. In any event in the *Cattermole-Trethewey* case, it is important to note that the court found independently of the taxpayer's motive of tax avoidance, that the acts done in respect of the implementation of the transaction were not indicative of an intent that a bona fide pension plan should be created.

63. 72 D.T.C. 6325.

64. *Supra* n. 44 at 528.

65. Indeed, at page 6329, in giving the reasons for its decision the Supreme Court said: "The legal rights and obligations which it created were exactly those which the parties intended. The incorporation of Independent, the making of the agreement, the resignation of the respondent, Steele and Symon were all a part of an arrangement worked out between J. K. Campbell, who controlled Campbell Limited, and the three senior employees of that company. Mr. Campbell, who desired to deal with a company, and not with the three individuals, gave them the opportunity to provide management for his company, through a company, incorporated for that purpose, for a fee based, in part, on the net profits of Campbell Limited. *This was done,* and, as the learned trial judge says, 'If a saving in income tax resulted to anyone that was incidental to the overall plan' ". (The italics are mine.)

66. For example, payments or expenditures that appear to have been made in respect of a transaction are shams if the intention of the person purportedly making them is that his financial resources or assets be no less than they were before the payments or expenditures were purportedly made. Such an intention would be extant if the manner of making the

thereof were shams.[67, 68] Fourth, the court concluded that the transaction was not a sham even though the inherent nature of the transaction was not expressive of a "business purpose". Indeed, the trial judge found as a fact[69] that the insertion of the management company between the taxpayer and another corporation (operating company), for which the taxpayer performed as employee the same services that he had performed as employee of the operating company before the insertion of the management company, was not for the purpose of providing more efficient management of the operating company. Indeed, the management company was to provide the means whereby the chief shareholder of the operating company could use current earnings, which otherwise would have been taxed as profits of the operating company, to liquidate his shareholdings in the operating company while concurrently maintaining a controlling hand over the operating company's business affairs during the period over which his shares were to be realized into cash.[70] In the

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purposed payment or expenditure was through a "round-robin" of cheques with the result that the payor remained in control and possession after the "payment" of the same resource that he had before the payment.

67. In the circumstances of this case there was definitely a tax avoidance motive. However, such a motive was irrelevant in the opinion of the trial judge for determining whether the transaction was a sham. Once it was found that the transaction was not a sham, the learned trial judge looked to the motive of the taxpayer for the purpose of determining whether the deduction in computing income of expenditures made in respect of the transaction would have the effect of "artificially" reducing the taxpayer's income pursuant to subsection 137(1) of the Income Tax Act. In respect of the issue of whether subsection 137(1) was applicable, Mr. Justice Cattenach in his judgment seemed to attribute to the *Shulman* case and the *Cattermole-Trethewey Contractors* case, both of which are discussed above, the principle that if the primary purpose of a transaction is tax avoidance, then any expenditure laid out in respect of the transaction is not deductible in calculating the taxpayer's income for to do so would "artificially" reduce the taxpayer's income. For the reasons indicated in my discussion of the *Shulman* case and the *Cattermole-Trethewey* case, I do not interpret those cases as establishing such a principle. In any event, even should the Supreme Court of Canada decide in the future that a taxpayer's tax avoidance motive automatically brings a transaction within the purview of subsection 245(1) of the Act, such a decision would have no effect on the principle that in determining whether a transaction is a sham the taxpayer's motive is irrelevant. (The Exchequer Court decision of *Cameron* v. *M.N.R.* is reported at 71 D.T.C. 5068.)

68. The Minister of National Revenue, no doubt, would like to interpret the utterance made by the Supreme Court of Canada in its concluding remark, namely, ". . . as the learned trial judge says, 'If a saving in income tax resulted to anyone that was incidental to the overall plan.", (*See supra* n. 65) as authority for the proposition that if the primary objective of the taxpayer is to avoid taxes the transaction is a sham, but if the motive of tax avoidance is of secondary importance in respect of the taxpayer's reason for setting up the transaction, the transaction is not a sham. Such an interpretation becomes manifestly erroneous when one looks to the context in which that statement was made by the trial judge. Indeed, that statement was made in the context of deciding whether for purposes of calculating the taxpayer's income a deduction in respect of expenditures laid out in respect of the impugned transaction (which had already been held as not being a sham) would result in an artificial reduction of the taxpayer's income. Moreover, if one looks to the context of the Supreme Court of Canada's decision where that statement of the learned trial judge is adopted by the Supreme Court as a closing remark, one could just as easily interpret that comment as meaning "if the legal rights and obligations purported to be created in respect of a transaction for external appearances are intended to be created, they will in law be created notwithstanding that the avoidance of taxes was associated with or was a constituent 'element of the overall plan whereby those rights and obligations were to be created as a result of its implementation' ". It is my opinion that the comment made in respect of the *Cameron* case by Mr. Justice Addy at page 6557 in the Federal Court—Trial Division decision of *Simard-Beaudry Inc.* v. *M.N.R.*, 74 D.T.C. 6552, is supportive of my interpretation of the decision of the Supreme Court of Canada, namely, the fact that the motive of the taxpayer in respect of a transaction is the avoidance of taxes, whether that motive be of primary or secondary importance to the taxpayer, is an irrelevant consideration in determining whether or not the transaction is a sham.

69. It was upon the learned trial judge's finding of facts that the Supreme Court of Canada applied the doctrine of the sham.

70. *See* 71 D.T.C. 5068 at 5077 (Ex.) and 72 D.T.C. 6325 at 6328 to 6329 (S.C.C.).

scenario, here, a management fee which was larger in amount than the aggregate of the salaries paid to the former employees of the operating company who continued to perform their same duties as employees of the management company, was paid to the management company to be used to purchase the common shareholdings of the principal shareholder of the operating company. At the time of this transaction there was no tax eligible on capital gains; accordingly, the principal shareholder, by entering into such an arrangement, was able to realize on his investment in the operating company without paying tax. Had he realized on his investment in the operating company by liquidating it or by distributing all of the retained earnings of the operating company as a dividend, the principal shareholder would have been subject to tax. Such a purpose as the latter is less indicative of a concern for the operations of a business and much more indicative of tax avoidance and estate planning purposes; and such purposes are nonetheless so because, in realizing his investment in the operating company by the manner chosen, the shareholder also satisfied his feelings of pride by providing for the continuance, after his retirement, of a business that he founded and which bears his name.

The Federal Court of Canada has on at least six occasions considered and applied the doctrine of the "sham" as espoused by Lord Justice Diplock in the *Snook* case[71] and applied by the Supreme Court of Canada in the *Cameron* case.[72] On some of those occasions it considered and pronounced on the related issue of "the motive of the taxpayer" or the "business purpose" of a transaction.[73]

The Federal Court—Trial Division decision of *Simard-Beaudry Inc.* v. *M.N.R.*[74] attributes the Supreme Court of Canada with adopting, as a principle of Canadian law, the doctrine of the sham as espoused in the *Snook* case; indeed, this decision interprets the *Cameron* case as deciding that, in determining whether a transaction is a sham the subjective motive of a taxpayer, whether it be tax avoidance or otherwise, is not a relevant consideration.[75] In this regard it is worthwhile quoting from the decision of Mr. Justice Addy, who gave the judgment of the Federal Court in that case:[76]

> On the other hand, in order to determine if a document constitutes a sham or not and for this reason must necessarily attract financial consequences, one must not take an exaggerated view of the motives of the parties for the sole purpose of arriving at an interpretation favourable to the taxing authority. The rule which lays down that the substance and the nature of the transaction must be considered, must not serve as a pretext for a detailed search into motives in order to attain a far-fetched or exaggerated interpretation of its exact nature.

This case is also interesting from the point of view of the circumstances the court considered must be extant before subsection 137(1) of the Income

71. *Supra* n. 44.

72. *Supra* n. 63.

73. This latter issue was the only issue considered in a seventh case which was argued before the Federal Court—Trial Division, viz., *Holmes et al.* v. *The Queen*, 74 D.T.C. 6143.

74. 74 D.T.C. 6552.

75. This is necessarily inferred at page 6557 of the court's decision when Mr. Justice Addy says: "Having regard to the manner in which the Supreme Court of Canada, in its unanimous judgment in the recent case of *The Minister of National Revenue* v. *James A. Cameron*, [1972] C.T.C. 380 [72 D.T.C. 6325], applied the definition contained in the case of *Snook* v. *London & West Riding Investments Ltd., supra*, to the circumstances of the *Cameron* case, it is clear, in my view, that the purchase by the appellant by means of an option does not constitute a sham in the legal sense. *In addition, . . . in the present case the main object and even the sole object of the Appellant was not to avoid the payment of tax . . .*" (The italics are mine.)

76. *Supra* n. 74 at 6556.

Tax Act (subsection 245(1) of the post 1971 Act) will have application. These circumstances are mutually exclusive: (1) The impugned expense must be made in respect of a sham transaction.[77] (2) The quantum of the impugned expense is greater than that which is necessary to produce the projected income.[78] It is clear from the reasons for judgment in the *Simard-Beaudry* case[79] that the Federal Court relied upon the authority of the *Shulman* case. Upon analyzing the *Shulman* case in regard to the interpretation given to subsection 137(1) of the Income Tax Act, it is clear that the Exchequer Court attributed the purpose of subsection 137(1) as being the complement of paragraph 12(1)(a) of the Act (paragraph 18(1)(a) of the post 1971 Act). That is, paragraph 12(1)(a) does not prohibit the deduction of any portion of the "quantum" of an expenditure laid out or an expense incurred as long as the "nature" of the expense is such that it is recognized by ordinary principles of commercial trading or accepted business practice as being normal for gaining or producing income from the particular activity for which it was incurred. However, where the quantum of the expense is "unduly" large as to be "unreasonable", subsection 137(1) may be involved to prohibit the deduction of that portion of the expense considered to be unduly large.[80] In determining whether the quantum of an expense is unduly large or unreasonable the following considerations are relevant: the scale on which the activity is undertaken, the profits which can reasonably be expected to be earned, and the benefits the taxpayer received as a result of making the expenditure or incurring the expense.

The interpretation given by the Exchequer Court in the *Shulman* case in respect of the purpose of subsection 137(1) of the Act was followed by the Federal Court—Trial Division in the cases of *Grotell* v. *M.N.R.*[81] and *Holmes et al.* v. *The Queen*.[82] In the latter case the Federal Court adopted

77. This circumstance was attributed by the court to the rationale behind the decision of the Exchequer Court in *Cattermole-Trethewey Contractors Ltd.* v. *M.N.R.*, 71 D.T.C. 5010.

78. These circumstances were expressed by the Federal Court at page 6558 of its decision as follows: "Unless there is a sham, section 137(1), in my view, cannot be invoked to deny an expense or a deduction where the revenue of the taxpayer who is claiming the depreciation, would not be reduced unduly or artificially". In respect of the circumstance of "undue" or "artificial" reduction of revenue the court goes on to say: "The original expense was made for the purchase at the reduced price of fixed assets which, according to the evidence submitted, will undoubtedly be used to produce revenue. *(Therefore it will not be prohibited as a deduction in calculating the taxpayer's income by virtue of paragraph 12(1)(a) of the Income Tax Act because it was an expense incurred for the purpose of gaining or producing income from a business or property.)* There is no evidence that these fixed assets will not be entirely required for this object. *(Accordingly, the amount of quantum claimed in respect of the expense is not 'unreasonable' or 'undue' according to the* Shulman *case,* 61 D.T.C. 1213, *an Exchequer Court judgment, affirmed by the Supreme Court of Canda.)* The original expense therefore cannot be an undue or artificial one . . .". The italicized words in parentheses are mine and were added for the purpose of explaining what was said by Mr. Justice Addy in his judgment.

79. *Supra* n. 74 at 6557 where the court in referring to the case of *Isaac Shulman* v. *M.N.R.*, 61 D.T.C. 1213, attributed that case as dealing "clearly and precisely with the definition and the effect of section 137(1)".

80. *See* the decision of Ritchie D.J. in the *Shulman* case at 1220 and 1221 thereof.

81. 72 D.T.C. 6409. In giving its reasons for judgment the Federal Court did not expressly refer to the *Shulman* case; however, from the decision of the Federal Court which reversed the Tax Appeal Board and the manner in which the court's reasons are reported which includes a direction by that court to refer to the Appeal Board decision where the interpretation of the *Shulman* case was in issue, the necessary implication is that the Federal Court followed the Exchequer Court's interpretation of subsection 137(1) in the *Shulman* case.

82. 74 D.T.C. 6143. The Federal Court expressly follows the interpretation given by the Exchequer Court in the *Shulman* case in respect of the purpose of subsection 137(1), that being, to act as a complement to paragraph 12(1)(a) which is only concerned with the nature of an expense, the quantum thereof being the concern of subsection 137(1).

the reasoning of Mr. Justice Ritchie in the *Shulman* case and concluded that the nature of a management fee is such that it has been recognized by ordinary principles of commercial trading and accepted business practice as an expense that is normally incurred for the purpose of gaining or producing income from a business. Accordingly, the deduction of such an expense was not prohibited by paragraph 12(1)(a) in computing income.[83] Moreover, since the quantum of the management fee was found to be normal (i.e., it was calculated at the current rate being paid by the business community for services of that kind), it was necessarily reasonable.[84] Therefore, its deduction did not unduly or artificially reduce the taxpayer's income pursuant to subsection 137(1) of the Act.[85] The *Holmes* case is also interesting from the point of view of the "business purpose" test. Indeed in that case the Minister of National Revenue argued that, since the expenses incurred by the management company for which the latter was reimbursed by the law firm could have been paid for directly by the law firm without interposition of the management company, there was no business reason for the interposition of the management company; thus, the fee paid by the law firm for its services was not deductible by virtue of paragraph 12(1)(a). In the alternative, the Minister argued that, should paragraph 12(1)(a) not be found to prohibit the deduction of a management fee, subsection 137(1) would prohibit its deduction.[86] In response to the Minister's "business purpose" argument the court said that, if the expense is recognized by the ordinary principles of commercial trading or accepted business practice as being one that is ordinarily incurred for the purpose of gaining or producing income from a business, its deduction in calculating a taxpayer's income from a business, is not prohibited by paragraph 12(1)(a) and as a result, it has an inherent business object or purpose. Thus, it appears the court decided that the motive of a taxpayer for entering into a transaction is not a relevant consideration for determining whether an expense has a "business purpose". Rather a consideration of the "business purpose" of an expense is limited to determining whether the nature of the impugned expense is recognized, by those persons whose ordinary business it is to carry on the activity in respect of which the expense was incurred, as an expense normally incurred in gaining or producing income from that activity. This proposition can be stated more succinctly. If the expense incurred is recognized by ordinary principles of commercial trading or accepted business practice as having been incurred for the purpose of earning profits from the activity for which it was incurred, it has a "business purpose" and accordingly, it is not prohibited from being deducted under paragraph 12(1)(a).[87] Moreover, the motive[88] of

83. *Id.* at 6150 and 6151.

84. At page 6151 the court seems to say that an expense is "reasonable", and hence if its quantum is commensurate with the commercial and business advantages which can be expected to flow from the performance of those services.

85. In this regard the court said at page 6151 of its decision: "There was evidence adduced that a management fee of 15% of the disbursements made on behalf of a customer is the normal and going rate for services of this kind. For that reason the payment of a management fee in that amount would not unduly reduce the income of the payor if the expense was incurred for legitimate business reasons". What the court means by "legitimate business" reasons is explained below.

86. *Supra* n. 82 at 6145.

87. Paragraph 12(1)(a) of the pre-1972 Act is the equivalent of paragraph 18(1)(2) of the post 1971 Act.

88. In this regard the Federal Court said at page 6151 of its decision:

> In my view the propriety of the deduction by a management fee falls to be decided upon a

the taxpayers for entering into the transaction in respect of which the expense is incurred (i.e., the avoidance of taxes or otherwise) is an irrelevant consideration for determining whether the business purpose test inherent in paragraph 12(1)(a) of the Act has been met.[89]

In 1976 the Federal Court of Appeal in the case of *Produits L.D.G. Produits Inc.* v. *The Queen*[90] applied the doctrine of the "sham" as adopted by the Supreme Court of Canada in the *Cameron* case.[91] Indeed, in determining whether the taxpayer intended to establish a genuine pension plan the court looked to the objective manifestations of the taxpayer's intent, that is, the acts done in pursuance of its obligations as contemplated by the written documentation of the plan, but disregarded the taxpayer's motive for establishing such a plan. Moreover, in considering the application of subsection 137(1) to the circumstances of that case, the Federal Court of Appeal categorically rejected the argument of the Minister of National Revenue that subsection 137(1) is to be interpreted as a deterrent to tax avoidance.[92]

In that same year, in the case of *Alberta and Southern Gas Co. Ltd.* v. *The Queen*,[93] the Minister of National Revenue argued before the Federal Court—Trial Division that, because the motive of the taxpayer in entering into an agreement was to avoid the payment of tax, the agreement was a sham; and in any event, since the expenditure laid out by the taxpayer in pursuance of that agreement did not have a "business purpose" but was made for the purpose of artificially reducing its income to avoid or reduce its liability for income tax, a deduction in respect of same was prohibited by subsection 245(1).[94] Both of these arguments were rejected by the court. In determining whether the agreement was a sham the court looked to the objective criterion of the "acts done" in pursuance of the agreement and decided that the taxpayer did precisely as he contracted to do; accordingly, the agreement was not a sham. Furthermore, in deciding that the expenditure was deductible, the court said that, regardless of the fact that the expenditure was laid out by the taxpayer as a tax avoidance

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determination of the question whether genuine business reasons existed for payment of the management fee under this contract.

In concluding that the payment of the fee was an expense incurred for the purpose of gaining or producing income from the plaintiff's business, I found that true business motivation existed with consequent business advantages.

89. Indeed, the decision of the Federal Court was made with cognizance of the fact that the taxpayer was motivated somewhat by the tax advantages which would result by having the non-legal services of a law firm performed by a management company, the shareholders of which were the wives of the partners in the law firm. In this regard *see* page 6149 of the court's decision.

90. 76 D.T.C. 6344.

91. *Supra* n. 63.

92. In this regard the Court of Appeal said at page 6349 of its decision that:

The only reason given by the Trial Division for its conclusion, and respondent did not suggest any other, was that appellant's principal aim in setting up its retirement plan was not to ensure that its employees received a pension, but rather to secure tax benefits for itself.

Assuming that appellant acted from the motives imputed to it in the judgment a quo (I, for my part, would have been tempted to conclude that the company was acting in the interests of its principal shareholder rather than in its own), it would not follow, in my opinion, that subsection 137(1) should apply here. There is nothing reprehensible in seeking to take advantage of a benefit allowed by the law. If a taxpayer has made an expenditure which, according to the Act, he may deduct when calculating his income, I do not see how the reason which prompted him to act can in itself make this expenditure non-deductible. I therefore believe that in the case at Bar, there is no reason to apply subsection 137(1).

93. 76 D.T.C. 6362.

94. *Id.* at 6369.

device, since it succeeded in bringing itself within the terms of provisions[95] specifically allowing the deduction, that concluded the matter, and the tax avoidance motive of the taxpayer was irrelevant.[96] Two principles can be drawn from this decision of the Federal Court: (1) A taxpayer's motivation is irrelevant for purposes of determining whether a transaction is a sham.[97] (2) Where a provision of the Income Tax Act expressly permits a deduction in respect of an expense incurred by a taxpayer, the incurrence of such an expense need not be associated with the accomplishment of some business objective in order for the expense to be deductible. In affirming the decision of the trial division the Federal Court of Appeal decided[98] that, where a taxpayer has succeeded in bringing itself within the parameters of an "incentive allowance",[99] subsection 245(1) could not be interpreted as a tax avoidance deterrent for the purpose of prohibiting the deduction of an expenditure laid out for the sole purpose of reducing the tax liability of a taxpayer.[100] This decision of the Federal Court of Appeal has been affirmed by the Supreme Court of Canada.[101]

In 1977, the Federal Court of Appeal in the case of *Massey-Ferguson Ltd.* v. *The Queen*[102] reversed the decision of its Trial Division[103] and held that the rights and obligations arising from relationships created by virtue of effecting a transaction in a certain manner cannot be disregarded for the purpose of determining a taxpayer's liability for tax. The rationale of this decision is comprised of two elements: The first is the application of the doctrine of the sham as espoused by Lord Diplock in *Snook* v. *London & West Riding Investments*[104] and adopted by the Supreme Court of Canada in the *Cameron* case.[105] In applying this doctrine to the circumstances of the *Massey-Ferguson* case, the court did not look to the "motive" of the taxpayer for undertaking the transaction;[106] rather, the court applied the doctrine as adopted by the Supreme

95. The provisions of section 66 of the Income Tax Act were in issue in this case.

96. *See* 6369 and 6370 of the court's decision.

97. The tautological equivalent of this statement is that a taxpayer's motivation is an irrelevant consideration in determining the substance of a transaction.

98. 77 D.T.C. 5244.

99. An "incentive allowance" was defined by the Federal Court of Appeal at page 5248 of its decision as being amounts that were not laid out for the purpose of earning profit but were made specifically for the tax advantage Parliament intended to bestow on the taxpayers who laid out such expenditures in return for achieving some economically or socially desirable end for the country as a whole.

100. This is a narrower view than that expressed by the Federal Court of Appeal in the *Produits LDG Products* case, 76 D.T.C. 6344, which categorically rejected the contention of the Minister of National Revenue that subsection 137(1), the equivalent of subsection 245(1) of the post 1971 Act, was to be interpreted as a provision of the Income Tax Act that had for its purpose the deterrence of tax avoidance.

101. The Supreme Court of Canada dismissed, without written reasons, the appeal of the decision of the Federal Court of Appeal, 78 D.T.C. 6566.

102. 77 D.T.C. 5013.

103. 74 D.T.C. 6529.

104. *Supra* n. 44 at 528.

105. In a footnote to page 5019 of its decision the Federal Court of Appeal attributed the Supreme Court of Canada as adopting in the case of *M.N.R.* v. *Cameron*, 72 D.T.C. 6325, the whole doctrine of the sham as espoused by Lord Diplock in *Snook* v. *London & West Riding Investments, Ltd.*.

106. In respect of the relevance of a taxpayer's motive for determining whether or not a transaction is a sham the court, in referring to the case of *M.N.R.* v. *Anthony Thomas Leon*, 76 D.T.C. 6299 where the Federal Court of Appeal held that the taxpayer's motive of "tax avoidance" or "lack of business purpose", whatever one chooses to call it, made the transaction a sham said at page 5020 of its decision that: "I am not at all sure that I would have agreed with the broad principles relating to a finding of a sham as enunciated in that

Court of Canada and in determining whether the transaction was a sham, limited its consideration to determining whether the rights and obligations which the parties purported to create for the eyes of a person who was not a party to the transaction, were in fact created. The court determined—by looking objectively to the "acts done" by the parties in effecting the transaction[107]—that the rights and obligations which were in law created were those which the parties to the transaction expressed as being their intention to create.[108]

The second element of the court's rationale for concluding as it did in this case was its adoption, as a principle of law having general application to the interpretation of the provisions of the Income Tax Act, the proposition espoused by the House of Lords in the case of *Inland Revenue Commissioners* v. *Brebner*,[109] that, if a transaction has a business purpose, it cannot be ignored for purposes of determining a taxpayer's liability for tax notwithstanding such liability would have been greater had it been effected in another manner. In stating this proposition the Federal Court of Appeal said:

> In general, it may be stated that if there are two ways in which a transaction may be carried out, one of which involves a liability for the payment of tax, and the other of which results in a reduction or elimination of such a liability, then, if the transaction is otherwise a bona fide commercial one, there is no reason for not adopting the tax saving method. That principle is stated succinctly in *Inland Revenue Commission* v. *Brebner* (1967) All E.R. 779 by Lord Upjohn at page 784, as follows . . ."

On reading the *Brebner* case it becomes clear that the United Kingdom had to enact subsection 28(1) of the United Kingdom Finance Act, 1960,[110] before the Commissioners of Inland Revenue in the United Kingdom could ignore a transaction that had "tax avoidance" as its object. Subsection 28(1) is a provision which was expressly enacted as a "tax avoidance deterrent" in respect of specified transactions in securities. Because the Income Tax Act does not have within its embodiment a similar tax deterrent provision,[111] there is no authority for the Minister of National Revenue to ignore the legal rights and obligations of a transaction in determining a person's liability for tax even though the motive or impetus for entering into the transaction is not a "bona fide commercial one". To adopt the provisions of subsection 28(1) of the United Kingdom Finance Act as a principle of Canadian law without the

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case, and, I think, that the principle so stated *(that is, if the agreement or transaction lacks a bona fide business purpose, it is a sham)* should perhaps be confined to the facts of that case. (The italics are mine.)

107. In the circumstances of this case there was no formal written document which on the face of it expressed the rights and obligations that the parties intended to create. The court was able to determine this intention by the evidence adduced of conversations, letters, memoranda, accounting records, financial statements and corporate minutes.

108. In respect of its finding that the transaction was not a sham Mr. Justice Urie in giving the judgment of the court said at pages 5019 to 5020 of its decision that: "The legal rights and obligations to which I have earlier referred were created in this case in the manner contemplated by all three parties. The condition necessary to find a transaction to be a sham, namely, not in fact to have created the legal rights and obligations which appear to have been created, thus was not present, with the result that the learned trial judge erred, in my view, in finding that it was a sham".

109. [1967] 1 All E.R. 779.

110. In the House of Lords decision of *Inland Revenue Commissioners* v. *Brebner* [1967] 1 All E.R. 779, the word "object" was interpreted to mean the subjective intention of a taxpayer, that is, his "motive" for undertaking to carry out a transaction.

111. Indeed, the only tax avoidance provisions of the Income Tax Act that have been expressly enacted as such are set out in ss. 95(6), 103(1), 146(1)(6), 247(1)(2).

authority of a statutory enactment[112] is tantamount to revivifying the doctrine of "the substance" which has categorically been laid to rest by the highest court of the land in both England and Canada.[113] Thus, since there is no statutory authority in the Canadian Income Tax Act for resurrecting the doctrine of "the substance", as it exists in England by virtue of subsection 28(1) of the U.K. Finance Act, 1960 and, since there are precedents in our case law that are of greater authority[114] than this *obiter dictum*[115] statement made by the Federal Court of Appeal in respect of the necessity that a transaction have a "bona fide commercial reason" for its undertaking, it is my opinion that this decision of the Federal Court of Appeal cannot be considered as establishing in Canadian income tax law a "business purpose" or "bona fide commercial reason" test which would enable the Minister of National Revenue to disregard the legal rights and obligations created by a transaction where the motive for the transaction was the avoidance of tax. It is to be noted that in its decision the Federal Court of Appeal itself questioned the validity of the proposition that, if the motive of a transaction is not for the achievement of some business purpose it is a sham and can therefore be ignored in determining a taxpayer's liability for tax. This proposition was espoused in an earlier decision of the Federal Court of Appeal, namely, that of *M.N.R.* v. *Anthony Thomas Leon.*[116]

The *Leon* case will be the last to be considered in this analysis of the case law in respect of the application of the doctrine of the "sham" and the "business purpose" test in the administration of the Income Tax Act. The reason this case was not discussed in the chronology of its occurrence in relation to the other cases discussed above is that it is, in my opinion, so obviously contrary to the authority of the precedential progression of the decided case law in respect of both the doctrine of the sham and the relevance of the business purpose of a transaction,[117] that it warrants separate consideration. Indeed, I am of the view that it should be denounced from the points of view of both its divergence from the legal authority of earlier judicial precedents and its perversity to the philosophy[118] of law that is the basis of our legal system.

In the *Leon* case the Court of Appeal claimed that in the *Cameron* case[119] the Supreme Court of Canada established the principle that, in

112. The effect of enacting subsection 28(1) of the U.K. Finance Act, 1960, is to incorporate into the U.K. law the doctrine of "the substance" with a very restricted scope. Indeed, subsection 28(1) is limited to specified transactions in securities. By reason of enactment itself, the obvious conclusion to draw is that the U.K. Parliament was cognizant of the lack of legal authority vested in the revenue officials to otherwise disregard the legal rights and obligations created in respect of a transaction that was not a sham.

113. *See* above pages.

114. The Supreme Court of Canada in the *Dominion Telegraph Securities* case, *supra*, the *Dominion Taxicab Association* case, *supra*, and the *Atlantic Engine Rebuilders* case, *supra*, and the Judicial Committee of the Privy Council in the *Pioneer Laundry* case, *supra*.

115. Indeed, the adoption of the "bona fide commercial reason" by the Federal Court of Appeal was not necessary to its decision because the court in fact found that the taxpayer had a business motive in undertaking the transaction.

116. 76 D.T.C. 6299.

117. In speaking of the "business purpose" test I have chosen to call it an issue because whether or not such a test will ultimately find its way into our case law still remains to be decided by the Supreme Court of Canada; whereas, the concept of the sham received its judicial sanction by the Supreme Court of Canada in the case of *M.N.R.* v. *Cameron* and accordingly has attained the status of a principle or doctrine of law.

118. The philosophy I speak of is the freedom to enter into relationships that have been recognized by our courts as conferring particular rights and obligations on the parties entering into those relationships.

119. *M.N.R.* v. *Cameron*, 72 D.T.C. 6325.

circumstances where the tax liability of one of the parties to a transaction is in issue, and the motive of that party for entering into the transaction was the avoidance of tax, the rights and obligations that would have otherwise been created[120] (because the "acts done" by the parties in effecting the transaction were consistent with the expressed[121] intent of the parties in respect of the rights and obligations that they wished to be created) may be disregarded for purposes of assessing that party's liability under the Income Tax Act. Does such a proposition sound familiar? It should! It is nothing more than a paraphrasing of the doctrine of "the substance" which has been denounced in Canada.[122] That the Supreme Court of Canada would revivify a heretofore "dead" doctrine without expressly stating its intention to do so, is reason enough to conclude that the *Cameron* case does not stand for such a proposition! Moreover, I am of the view that an analysis[123] of the *Cameron* case itself makes it manifest that the Supreme Court of Canada has adopted, pure and simply, the doctrine of the "sham" as espoused by Lord Justice Diplock in *Snook* v. *London & West Riding Investments Ltd.*[124] And, it is obvious from such statement of the doctrine of the sham that the motive for a transaction is an irrelevant consideration for determining whether the legal rights and obligations which the parties appear to have created were in fact intended. Indeed, the taxpayer's "intent" in respect of the rights and obligations that he desired to create by entering into a transaction is a completely different consideration than the reason or motive for entering into the transaction. It is my opinion that the Court of Appeal in deciding in the *Leon* case that the transaction was a sham because the impetus or motive for entering into the transaction was the avoidance of taxes rather than to accomplish some commercial objective, i.e., a "business purpose", misapplied the doctrine of the sham as it was adopted by the Supreme Court of Canada as a principle of Canadian law. Accordingly, because the proposition of law that the *Leon* case attempts to espouse is inconsistent with that espoused by the Supreme Court of Canada in the *Cameron* case, its weight as a judicial precedent is at best miniscule.

It appears from the reasons for judgment given in the *Leon* case that the Court of Appeal defines "business purpose" in terms of what the Federal Court—Trial Division in the case of *Holmes* v. *The Queen*[127] viewed as being "genuine business reasons". In that latter case, it is manifest from the court's reasons for judgment that it considered an expense incurred or an expenditure laid out in respect of a transaction to have a legitimate business reason if, according to the ordinary principles of commercial trading or accepted business practice, it was normal for an expense of such a nature to be incurred for the purpose of gaining or producing income from a business or property. In the *Holmes* case the court found that the management fee paid by a law firm in respect of

120. That is, otherwise created according to our laws of property and civil rights.

121. This expressed intent may be gleaned from the formal written documentation in respect of a transaction, or if there is no such formal written contract, from other evidence of an objective nature.

122. *See* above.

123. *See* above.

124. *Supra* n. 44. *See* above where words expressive by the doctrine of the sham are quoted from the judgment of Justice Diplock.

125. *Id.* at 528.

126. *Supra* n. 116 at 6302.

127. *Supra* n. 82.

services performed by a management company incorporated especially for the purpose of performing such services, even though those services could have been just as easily performed by the employees of the law firm itself, was from the point of view of the business community, an expense normally incurred in the process of earning profits from a business. Accordingly it had a legitimate business purpose.[128] The necessary inference that flows from the court's finding that the management fee had a legitimate business purpose is that both the management company itself and the performance by it of the services for which the management fee was paid, also had legitimate business reasons. Thus, it appears that the Court of Appeal misapplied the *Holmes* case by calling on it for authority to deny the existence of a business purpose in respect of the interposition of the management companies in the circumstances of the *Leon* case.

The Court of Appeal cited the Exchequer Court decision of *Legace* v. *Minister of National Revenue*[129] as authority for disregarding the separate legal existence of the management companies in the *Leon* case. In the *Legace* case the court found that there never was an agency or employment contract between the company and its shareholder, nor was there any contract between the company and another person in respect of the particular transaction; rather, the court found as a fact that it was the shareholder who contracted on his own behalf with that other person and that the purpose of the company was merely to hold the property as nominee of the shareholder. This is certainly not the factual situation in the *Leon* case; indeed, in that case there was both an employment contract between the taxpayer and the management company and a contract for services between the management company and a third party. Thus, it would appear that the *Legace* case was not good authority in the *Leon* case for denying the separate legal existence of the management company from the taxpayer.

The final authority on which the Federal Court of Appeal relied in the *Leon* case for denying the separate legal existence of the management company from its shareholder is the English Court of Appeal decision of *Littlewoods Mail Order Stores Ltd.* v. *McGregor*.[130] The fact pattern of this case is not unlike the *Legace*[131] case. Indeed, it is evident from the circumstances of the *Littlewoods* case that the wholly-owned subsidiary of the taxpayer was used as a nominee-holder of property for which the taxpayer itself had contracted to purchase; and moreover, there never was any intent that the wholly-owned subsidiary be a party to the transaction. Thus it would appear that the *Littlewoods* case was also not good authority for denying the separate legal existence of a management company from its shareholder in the circumstances which existed in the

128. For an analysis of the case *see supra*.

129. 68 D.T.C. 5143.

130. (1967) 45 T.C. 534.

131. *Supra* n. 129.

132. At page 536 of his decision in the case cited as (1967) 45 T.C. 584, Lord Denning says: "The doctrine laid down in *Salomon* v. *Salomon & Co.* [1897] A.C. 22 has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can, and often do, draw aside the veil. They can, and often do, pull off the mask. They look to see what really lies behind. . . . I think we should look at the Ford Manufacturing Co. Ltd. and see it as it really is. . . . It is the creation, the puppet, of Littlewoods, in point of fact and it should be regarded in point of law. The basic fact here is that Littlewoods, through their wholly-owned subsidiary, have acquired a capital asset . . ."

Leon case. Moreover, it would appear that the Court of Appeal's reliance on the statement made by Lord Denning in the *Littlewoods* case on "lifting the corporate veil"[132] as general authority for denying the separate legal existence of a corporate entity from its shareholders, is a misapplication of the principle of law that was espoused by Lord Denning in that case. Indeed, it is well known that in very limited circumstances, as when there is evidence of fraud or improper conduct,[133] or evidence that the corporate entity is a mere agent of or nominee holder of property for its shareholder as in the circumstances of the *Littlewoods* case,[134] the courts do lift the corporate veil. However, where, as in the *Leon* case, the corporate entity contracts on its own behalf, notwithstanding that its shareholder does the actual negotiating as employee thereof, our courts do not have general authority to deny the separate legal existence of the corporate entity in the absence of some statutory authority to do the same, or in the absence of circumstances where there is evidence of any fraud or improper conduct, an agency or trust relationship, or acts infringing public policy or that are criminal or quasi-criminal in nature.[135]

IV. CONCLUSIONS

This completes the discussion of the case law in respect of the relevance of the doctrine of the substance, the doctrine of the sham and the business purpose of a transaction when determining whether the rights and obligations that appear to have been created by the parties to a transaction can be ignored by the Minister of National Revenue for purposes of assessing a taxpayer's liability for tax. It is in my opinion that the following conclusions of law can be drawn from this discussion.

1. The so-called doctrine of "the substance"[136] has been categorically denounced as a principle of law that may be applied by the Minister of National Revenue in determining a taxpayer's liability for tax under the provisions of the Income Tax Act.
2. The particular legal environment that a taxpayer creates of his own volition in respect of the rights and obligations with which he is invested and encumbered as a result of the legal relationships into which he has entered in respect of a particular transaction, is the context within which the provisions of the Income Tax Act are to be applied. And, this legal environment may not be disregarded for the purpose of assessing a taxpayer's liability for tax where such liability would have otherwise been greater had the taxpayer not created the particular legal environment.
3. The only circumstance wherein a court may disregard the rights and obligations that appear to be created by the written documentation of, and the acts performed by, the parties in pursuance of a proposed transaction, is where the court determines that the true intention of the parties to the transaction is not to create those rights and obligations but is, rather, to create, if at all, other rights

133. *Supra* n. 32 *per* Lord Thankerton at 499-72.

134. The *Littlewoods* case, (1967) 45 T.C. 584 is cited by Gower, *Modern Company Law* (3rd), c. 10 at 204 as an example of a case where the court lifted the corporate veil to see whether the corporate entity was the mere agent of, or nominee holder of, property for the shareholders.

135. There are a few other situations where the corporate veil will be lifted. *See generally* Gower, *Modern Company Law* (3rd), c. 10.

136. *Supra* n. 1.

and obligations. In such circumstance those other rights and obligations will constitute the legal environment that is applicable to the parties for the purpose of applying the provisions of the Income Tax Act when assessing their respective liabilities for tax.

4. In determining the intention of the parties to a transaction in respect of the rights and obligations that they desired to be created in giving it legal effect, the court looks to the manifestation of their intent as revealed in the objective evidence adduced before it which may consist of such things as the parties' conduct in giving effect to the transaction, the respective accounting entries made by the parties, the intra office memoranda of each of the parties and the inter office correspondence between the parties.
5. The motive that any of the parties has in respect of entering into a proposed transaction is not relevant for determining the intention of the parties in respect of the rights and obligations, if any, they wished to create in giving legal effect to the transaction. Accordingly, a finding by the court that the taxpayer's motive for entering into a transaction is the complete avoidance or the reduction of his liability for tax under the provisions of the Income Tax Act is an irrelevant consideration for purposes of determining the taxpayer's intention in respect of the rights and obligations he desired to be created in respect of the proposed transaction. However, where the taxpayer's motive is obviously that of tax avoidance, a cautionary word of advice is offered. It is necessary to ensure that the rights and obligations which are intended to be created are in fact created in law. In other words, it is necessary to ensure that everything that must be done to give the desired legal effect to the transaction, is in fact done; otherwise, a taxpayer may find himself in exactly the same position "tax-wise" had the transaction never been entered into. Indeed, a court may very well cast a critical eye on the objective evidence of the taxpayer's intention for the purpose of determining the legal environment in which a provision of the Income Tax Act is to be applied if the court is cognizant that the motive behind the transaction is tax avoidance. Indeed, in this regard the Chief Justice of the Federal Court of Appeal had this to say:[137]

> It does not seem to be in doubt that the reason for the scheme under which the corporations in question would be constituted a partnership . . . was to achieve tax advantages for the individuals owning the shares of some or all of these corporations. While this does not affect the result actually achieved by what was done, it does, in my view, warrant a very careful appraisal of the evidence when considering whether what was projected with that end in view was actually carried out.

6. The only requirement under the Income Tax Act for a "business purpose" relates to the deductibility under paragraph 18(1)(a) of an expense incurred or expenditure laid out in calculating a taxpayer's income from a business or property. Such paragraph prohibits the deduction, in calculating a taxpayer's income from a business or property, of an expense incurred that is not recognized by the commercial or business community as being a normal or usual expense of earning profits from a property or business of the same nature as that in respect of which the expense was incurred. This

137. *Rose* v. *M.N.R.*, 73 D.T.C. 5083 *per* Chief Justice Jackett at 5085.

"business purpose" test has evolved from judicial interpretation of paragraph 18(1)(a) and its predecessors.[138]

7. There is no business purpose test inherent in subsection 245(1) of the Income Tax Act other than that which relates to the "quantum" of an expense incurred or an expenditure laid out. In other words, if the "nature" of the expense incurred is recognized by the commercial or business community as being normal or usual for the property or business in respect of which it was incurred, paragraph 18(1)(a) does not prohibit the deduction of any of the "quantum" of the expense for purposes of calculating a taxpayer's income under the Income Tax Act. However, to the extent the "quantum" or "amount" of the expense incurred in respect of a particular activity is "unreasonable" in relation to either, the benefits and profits that can be expected to accrue from its expenditure, or the degree to which the activity has been undertaken by the taxpayer, subsection 245(1) of the Act may be invoked to prohibit that portion of the expense that is greater than what a reasonable man, who is knowledgeable in the affairs of the particular activity, would consider to be appropriate.

This interpretation of the "purpose" and "effect" of subsection 245(1) has evolved through judicial interpretation. It appears the original purpose of the predecessor to subsection 245(1) was to prevent the deduction of an expense that was not recognized by the commercial and business community as being usual or normal for the type of profit making activity in respect of which it was incurred. Indeed, when the predecessors to paragraph 18(1)(a) and subsection 245(1) were inserted into the Income War Tax Act there was no precedent in the case law (as there is now) that had adopted the "ordinary commercial trading and business practice test" in respect of the nature that an expense must have before it is deductible in calculating a taxpayer's income. Accordingly, as a proviso to paragraph 6(1)(a) of the Income War Tax Act, subsection 6(2) was inserted therein.[139] This provision contained both the "nature" and "quantum" test of the deductibility of an expense in calculating a taxpayer's income for the purpose of the Income Tax Act. Judicial interpretation has made subsection 245(1) redundant[140] in respect of the "nature" part of the test of deductibility but

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138. *See Canadian General Electric Co. Ltd.* v. *M.N.R.*, 61 D.T.C. 1300 (S.C.C.); *Oxford Motors Ltd.* v. *M.N.R.*, (1959) S.C.R. 548 (59 D.T.C. 1119) *per* Abbot J. at 553; *M.N.R.* v. *Anaconda American Brass Ltd.*, 55 D.T.C. 1220.

139. Paragraph 6(1)(a) and subsection 6(2) of the Income War Tax Act, R.S.C. 1927, c. 97 read:

> 6(1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
>
> (a) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;
>
> (2) The Minister may disallow any expense which he in his discretion may determine to be in excess of what is reasonable or normal for the business carried on by the taxpayer, or which was incurred in respect of any transaction or operation which in his opinion has unduly or artificially reduced the income.

140. Subsection 245(1) also becomes redundant in respect of the "quantum" part of the test of deductibility when one considers section 67 of the Income Tax Act which reads as follows:

> 67. In computing income, no deduction shall be made in respect of an outlay of expense in respect of which any amount is otherwise deductible under the Act, except to the extent that the outlay or expense was reasonable in the circumstances.

It should also be noted that in the *Holmes* case, 74 D.T.C. 6143, Mr. Justice Cattanach infers that the "quantum" test of deductibility is also inherent in paragraph 18(1)(a).

that is not reason enough for the Minister of National Revenue to employ it as a "deterrent" provision for tax avoidance. Indeed, in this regard I would like to quote the Exchequer Court of Canada:[141]

> I would think that if it is desired to have an effective deterrent to a tax avoidance practice which is considered to be against the public interest, Parliament should legislate (as it has in some cases, such as with respect to dividend stripping in section 138A) so as effectively to block it. The court should not be asked to accomplish the task, . . . There is indeed no provision in the Income Tax Act which provides that, where it appears that the main purpose or one of the main purposes for which any transaction or transactions was or were effected was the avoidance or reduction of liability to income tax, the court may, if it thinks fit, direct that such adjustment shall be made as respects liability to income tax as it considers appropriate so as to counteract the avoidance or reduction of liability to income tax which would otherwise be effected by the transaction or transactions. The only authority of this character conferred by the statute is conferred on Treasury Board by section 138.

This statement has even received the sanction of the Supreme Court of Canada through that court's express adoption of the Exchequer Court's reasons for judgment.[142]

8. The business purpose of an expense incurred in respect of a transaction is neither affected by, nor determined from, the subjective motive of a taxpayer for entering into the transaction; indeed, the two considerations are totally unrelated. Whether or not an expense has a business purpose is determined from its nature, that is, if it is recognized by the business and commercial community as being normal for the activity in respect of which it was incurred, it has a business purpose and is therefore deductible pursuant to paragraph 18(1)(a). However, the motive for entering into a transaction is the subjective impetus or reason for entering into the transaction.
9. Just as the rights and obligations that a taxpayer is encumbered with in respect of a transaction that has been legally effected cannot be disregarded for the purpose of assessing his tax liability where the latter would have been greater had the transaction not been entered into, the separate legal existence of a management company from its controlling shareholder cannot be ignored, in the absence of fraud, improper conduct or statutory authority, where the management company is not the mere nominee of such shareholder.

141. *Foreign Power Securities Corp. Ltd.* v. *M.N.R.* 66 D.T.C. 5012 *per* Noel J. at 5027. It should be noted that since tax reform in 1972, there has been added to the provisions of the Income Tax Act two additional tax avoidance deterrent provisions, namely, subsections 95(6) and 103(1).

142. Indeed, at 67 D.T.C. 5084 the Supreme Court without stating anything additional, decided the appeal to that court by expressly adopting as its own, the reasons given by the Exchequer Court.