

Tax

Federal Court of Appeal decision creates uncertainty, tax lawyers say

By **Amanda Jerome**

(February 12, 2018, 10:48 AM EST) -- When tax lawyer Robert Kepes read the Federal Court of Appeal's decision in *Canada v. Oxford Properties Group Inc.* 2018 FCA 30, he sighed.



Robert Kepes, Morris Kepes Winters LLP

"Another GAAR [General Anti-Avoidance Rule] win for the Department of Justice and the Canada Revenue Agency [CRA]," he said, adding that he was disappointed in the ruling.

The *Oxford Properties* decision sprung from an appeal of a Tax Court of Canada decision in which Justice Steven D'Arcy allowed Oxford's appeal from a reassessment of its 2006 taxation year by the minister of National Revenue.

According to court documents, the reassessment was issued over a sequence of transactions involving property which occurred over a span of five years. The assessment was done in accordance with the GAAR, under s. 245 of the *Income Tax Act*.

The GAAR analysis engages three questions: "was there a tax benefit? If so, were the transactions which gave rise to this benefit avoidance transactions? If so, were the avoidance transactions abusive?"

"The Tax Court judge held that the series of transactions undertaken by Oxford, which involved rolling three real estate properties through a tiered partnership structure, increasing the adjusted cost base of the partnership interests and selling these interests to tax-exempt entities without tax being paid on the latent recapture and accrued gains in the property held by the partnerships, not to amount to abusive tax avoidance," wrote Chief Justice Marc Noël at the Federal Court of Appeal.

On the appeal, the Crown argued that Justice D'Arcy misinterpreted the provisions of the *Income Tax Act*, which led to a "beneficial tax treatment." The Crown asked the Federal Court of Appeal to interpret the provisions while focusing on their "object, spirit and purpose."

Oxford, the respondent, supported Justice D'Arcy's conclusion and noted that if the GAAR applies the tax adjustments resulting from the reassessment exceed the abuse and are therefore unreasonable.

Chief Justice Noël, with Justices Eleanor Dawson and Donald Rennie in agreement, determined in a decision released Feb. 1 to allow the appeal in part and set aside the decision of Justice D'Arcy.

"I would refer the reassessment back to the minister [of National Revenue] for reconsideration and reassessment on the basis that subsection 100(1) gives rise to a taxable capital gain in the amount of \$116,591,744.00 rather than \$148,187,562.00," wrote Chief Justice Noël.

Reaction to the decision from Toronto tax lawyers is that the decision creates uncertainty and that an appeal to the Supreme Court is not out of the question.



Ian Crosbie, Davies Ward Phillips & Vineberg LLP

"The case involves a transaction where properties were being sold in a corporate transaction. In advance of the sale of the company, the real property it owned was transferred to partnerships and then the company was sold," explained Ian Crosbie, a partner at Davies Ward Phillips & Vineberg LLP.

"It's wound up in what's called a 'bump' that is applied to increase the tax cost of the partnership interests to fair value. Sometime later, those partnership interests were sold to tax exempt purchasers. There's no tax on that sale because the tax cost has been stepped up from the bump transaction. There's a rule in the *Income Tax Act* that says if you sell a partnership interest to a tax exempt [purchaser] and you have a gain on that sale, if that gain doesn't relate to effectively gain on land or gain on shares then it's taxed as ordinary income, not as a capital gain," he added.

Crosbie said the bump transaction in this case meant that that *Income Tax Act* rule didn't apply because there wasn't a gain. He explained that by selling the partnership interests instead of selling the underlying properties there was no recapture of depreciation, which would have occurred if the properties and buildings had been sold.

"The [company] found a way to sell the property through this transaction to a tax exempt without triggering that recapture," he said.

Crosbie believes the Federal Court of Appeal decision will create unpredictability in a number of ways.

"The first is that its approach to analyzing the purpose of the various statutory provisions is very hard to follow," he said.

"The judge just decides what he thinks the purpose of the provision is. He looks at the rules and he concludes what he thinks the purpose is. He doesn't point to any external evidence to support his conclusion. We can't tell what was argued in front of him. There's a certain amount about the position of the two parties, but it's not so much a reasoned explanation of the purpose, as it is his decision on what the purpose is," he added.

Crosbie said tax lawyers like to see an explanation of the rationale behind decisions, especially when it comes to something as important as the bump provision.

"The second area for confusion to me is that he [Chief Justice Noël] concludes that three different rules were abused: the rule that let them transfer the property into the partnership without paying tax in order to set up the transaction; the bump rule that let them step up the cost of the partnership; and then the section 100 rule which would tax a gain on the partnership interest if there was one," he said.

"He concludes that all three of those are abused and therefore that the GAAR applies, but he doesn't explain how you're supposed to go from the conclusion that they've been abused to the conclusion that GAAR applies. Is it important that all three rules were acting together? Which components of these three abuses were necessary in order to find that the GAAR applies? It's not in the judgment. You can't tell," he added.

Crosbie believes the decision is going to create issues for merger and acquisition transactions as it's ambiguous

to what can and can't be done under the bump provision. He also notes that uncertainty stretches to the rollover provision to set up partnerships.

"After this transaction was done they changed the laws, so it's not as if people are going to try and do this exact transaction anymore. But I see it creating uncertainty with respect to potentially a wide range of other transactions," he said.

Kepes, a co-founder and partner at Morris Kepes Winters LLP, said the Oxford transaction was acceptable under the law at the time it was conducted, which is why the CRA invoked the GAAR. He noted that the GAAR allows the government to "recast the tax consequences."

"It basically doesn't force a particular result. It just says that the minister can recharacterize the transaction to get a reasonable tax result. That's what the GAAR does. At the time, the transaction technically worked under the law and that's why they have to invoke the GAAR," he said.

Kepes said the government changed the law to prevent the kind of transaction conducted by Oxford from happening again.

"One of the distinctions between the trial decision and the Federal Court of Appeal decision is the government had argued that when it comes to a change in the law there are some changes that create new law and there are other changes that clarify existing law," he said, adding that the Crown argued the changes to the provisions were clarifying amendments.

Kepes thinks the main takeaway of this decision is the effect amendments have on the *Income Tax Act*.

"They didn't put in a new section of the *Income Tax Act* that created new law or new policy. What they did was they amended an existing law. So the Tax Court judge had one view as to what is the effect of that amendment, whereas the Federal Court of Appeal had a different view. Their view was that the subsequent amendment really was in the nature of a clarification," he said, drawing attention to paragraph 90 of the decision.

Paragraph 90 noted that the question of whether a new subparagraph operates as new law in a GAAR context must be assessed with regard to the prior provisions meaning.

"One of the things I find really of interest in this case is the different views of what is the effect of an amendment to the *Income Tax Act* and the two different views of the Tax Court judge and the Federal Court of Appeal. The Federal Court of Appeal says 'these amendments were really just clarifying a policy that was already there,' " he explained.

Kepes said the big picture result of this decision is that the GAAR has teeth and, for the moment, it's a win for the Crown.

Counsel for the respondent and the appellant declined to comment on the decision.