

## Tax Law Update

# Lehigh Cement: more uncertainty surrounding GAAR

June 2010

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On May 17, 2010, the Federal Court of Appeal (FCA) released its decision in the case of *Lehigh Cement Limited v. R.* In a unanimous judgment, the FCA allowed the taxpayer's appeal and set aside an assessment issued by the Canada Revenue Agency (CRA) under the general anti-avoidance rule (GAAR) in the *Income Tax Act* (ITA). This assessment had previously been upheld by the Tax Court of Canada. For the most part, the FCA has exercised considerable restraint in its appellate review of tax cases involving the GAAR. While the decision of the FCA in *Lehigh* marks just the second time that it has overturned a decision of the Tax Court involving the application of the GAAR, it may signal a judicial trend to combat what some Tax Court judges, and perhaps the FCA, view as the inappropriate use of the GAAR as a means to fill perceived gaps in the ITA.

In *Lehigh*, the sole issue to be decided by the FCA was whether the GAAR was applied properly by the CRA to impose non-resident withholding tax on interest payments that satisfied the technical requirements of the exemption in former subparagraph 212(1)(b)(vii) ("Exemption"). In general terms, the Exemption applied to interest paid or credited by a corporation resident in Canada to a non-resident person provided that (i) the payor and the payee dealt at arm's length, and (ii) subject to certain exceptions, the payor could not be required to pay more than 25% of the principal amount of the debt within five years of the date on which the debt was issued.

The relevant facts in *Lehigh* are straightforward. In the mid-1980s, the taxpayer, a Canadian-resident affiliate of a multi-national corporate group, borrowed money from a consortium of Canadian banks. By 1997, the debt was held by a non-resident affiliate of the taxpayer. Interest on the debt was subject to non-resident withholding tax under former paragraph 212(1)(b). In order to eliminate the withholding tax (i) the terms of the debt were amended to meet the technical conditions for qualifying for the Exemption, and (ii) the non-resident affiliate stripped five years of interest payments on the debt and sold them at a discount to a Belgian bank with whom the taxpayer dealt at arm's length. Structured in this manner, the stripped interest payments satisfied the technical requirements for the Exemption despite the fact that the principal amount of the debt continued to be held by the non-resident affiliate. The taxpayer was subsequently reassessed by the CRA under the GAAR for failing to deduct and remit withholding tax on the interest payments it made to the Belgian bank.

Since the taxpayer conceded the existence of both a tax benefit and an avoidance transaction, the first two steps in the three-step GAAR analysis, the only remaining GAAR issue to be decided by the Tax Court was whether the transaction resulted in a misuse or abuse of the Exemption (i.e., the final step of the GAAR analysis).

According to the Supreme Court of Canada in *Canada Trustco*, the leading authority on the application of the GAAR, when determining whether there has been a misuse or abuse of a provision of the ITA, it is first necessary to interpret the provision to determine its object, spirit and purpose, with reference to the text of the provision, its surrounding context and its legislative purpose. The next step is to determine whether the transaction in question frustrated that object, spirit and purpose. In applying this framework, the Tax Court concluded that the purpose of the Exemption was to assist Canadian corporations in accessing international capital markets on a competitive basis by exempting from withholding tax interest paid to arm's length non-resident lenders. The Tax Court held that the Exemption was intended to apply only to the "arm's length borrowing of capital from a non-resident lender." Based on this reasoning, the Tax Court concluded that even though the interest was being paid to an arm's length non-resident, the Exemption was abused by the taxpayer because it did not borrow any money from the non-resident bank (or any other non-resident lender).

In reversing the Tax Court's decision, the FCA concluded that the CRA's evidence as to the purpose of the Exemption was insufficient to satisfy the misuse or abuse test from *Canada Trustco*. In particular, the FCA noted that all the commentary relied upon by the Tax Court related to one statement made in a budget paper released by the Department of Finance in 1975 (when the Exemption was first proposed). Against what it considered to be a "shaky foundation for an assessment under the [GAAR]", the FCA noted that (i) the wording of the Exemption was clearly broad enough to apply to an interest strip transaction and only requires the Canadian resident borrower to deal at arm's length with the recipient of the interest (and not the owner of the principal), and (ii) interest stripping transactions are not new or unusual and, indeed, they were contemplated by another provision of the ITA at the time the Exemption was enacted. The FCA acknowledged that the statement in the 1975 budget paper was of some relevance, but concluded that it was not, in and of itself, sufficient to establish the legislative purpose behind the Exemption for the purposes of the GAAR.

In the course of its judgment, the FCA recognized the difficulty Parliament faces in drafting tax legislation and notes and that, when doing so, it cannot describe every transaction that is within or without the intended scope of a provision. However, it also warns that the fact that a taxpayer relies on a provision of the ITA in an unforeseen or novel manner does not necessarily mean that there has been a misuse of the provision. In the words of the FCA, "the Crown cannot discharge the burden of establishing that a transaction results in a misuse of [an exemption] merely by asserting that the transaction exploits a previously unnoticed legislative gap." These words echo comments by the Tax Court in *Landrus* and repeated in *Collins & Aikman* to the effect that the CRA's use of the GAAR to fill in what it perceives to be a possible gap left by Parliament is not appropriate.

In *Lipson*, the Supreme Court of Canada was significantly divided on the question of whether a particular series of transactions resulted in a misuse or abuse of one or more provisions of the ITA. The post-*Lipson* cases, including *Lehigh*, reflect a similar lack of consensus within the judiciary regarding the scope of the GAAR and the application of the misuse and abuse test. It is hoped that the Supreme Court of Canada will provide more clarity in the upcoming appeal in the *Copthorne Holdings* case.

The FCA's decision in *Lehigh* is likely to be received as a taxpayer-friendly approach to applying the GAAR, in that it appears to impose a significant evidentiary burden on the CRA to establish misuse or abuse. Based on *Lehigh*, in order to successfully defend an assessment under the GAAR, it appears that the CRA will need to provide compelling evidence of a clear legislative objective that has been frustrated by the transaction at issue.