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The Westminster Principle

by

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The law says that a taxpayer is entitled to legally arrange her affairs to mitigate tax. Tax planning involves analysis of legislation and its judicial interpretation. Under our system of parliamentary supremacy, legislatures write laws, and courts interpret them.

Tax planning has always stimulated innovative and creative tax schemes. The early history of taxation is the story of how rulers impose innovative taxes to finance wars and how taxpayers devised creative ways to avoid the levies. Tax avoidance appears 4500 years ago in Mesopotamia, where a king levied fines on his citizens who began to swim across the local river to avoid the toll that he had imposed on the local ferry to finance his wars. The king responded with an anti-avoidance rule by making swimming across the river illegal. Here we see the DNA of the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax Act*.

Judicial Antecedents

It is a fundamental principle of Anglo-Canadian law that a taxpayer is entitled to arrange his or her affairs to minimize tax. This principle has its origins in two of the House of Lords. The first is *Bradford (City) v. Pickles*, [1895] A.C. 587 (U.K. H.L.):

> If it was a lawful act, however ill the motive might be, he had a right to do it. If it was an unlawful act, however good his motive might be, he would have no right to do it. [*Per* Lord Halsbury L.C., at p. 594.]
>
> No use of property, which would be legal if due to a proper motive, can become illegal because it is prompted by a motive which is improper or even malicious. [*Per* Lord Watson, at p. 598.]

The second, and more frequently quoted, decision is the judgment of the House of Lords in the *Inland Revenue Commissioners v. Duke of Westminster* [1936] A.C. 1 (U.K. H.L.), which was the

origin of the principle by the same name.

The Westminster Principle

The *Westminster principle* is fundamental in Anglo-Canadian tax law and has been since the House of Lords decision in 1936. Over time, however, tax law balances the interest of the state in revenue collection and the interest of taxpayers. As we have moved from the free market era of the mid-war years of the 20th century towards a more regulatory state, tax law has adapted through statutory changes to new demands of revenue generation. Nevertheless, the principle remains fundamental in tax planning, even if it is circumscribed by specific anti-avoidance rules (SAARs) and the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax Act* [*ITA*].

Background of The Duke of Westminster[1]

Hugh Richard Arthur Grosvenor, 2nd Duke of Westminster was not impoverished. He was a British landowner and one of the wealthiest men in the world. His ancestral country estate in Cheshire, the 54-bedroom Eaton Hall, consisted of 11,000 acres of parkland, gardens and stables.

For sea excursions, he had his choice of two sailing vessels, "The Cutty Sark", and a yacht, "Flying Cloud". For ground transportation he had 17 Rolls Royce automobiles and a private train built to facilitate travel from Eaton Hall directly into his London townhouse, Grosvenor House, in Mayfair.

The Duke died in 1953, aged 74. His estate attracted then-record death duties of £18m, which took his estate 11 years to pay off to the Inland Revenue.

The Political Climate

1936 was a significant year in modern history. King-Emperor Edward VIII abdicated the British throne, the Spanish Civil War started, and Jesse Owens won four gold medals, in the 100m, 200m, 4x100m relay, and the long jump, in the Berlin Olympics. He broke or equaled nine Olympic records and set three world records. One of those world records was in the 4x100m relay. The quartet set a time that wouldn't be bettered for 20 years. Adolf Hitler, who had a limited knowledge of Aryans, had hoped that the Berlin Games would prove his theory of Aryan racial superiority. Instead, Owens' achievements led the people of Berlin to hail Owens, an African American, as a hero.

The Tax Plan

Notwithstanding his wealth, the Duke was anxious to save tax on his retainers. The Duke employed a gardener and paid him a wage of £3 a week from his post-tax income. To reduce his tax liability, the Duke's solicitors advised him to stop paying the gardener's wage and instead draw up a covenant, agreeing to pay an equivalent amount as an annuity (annual payment) at the end of every specified period. Under the tax laws of the time, this allowed the Duke to claim the expense

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[1] Wikipedia.

as a deduction, thus reducing his taxable income and his liability towards income tax and surtax. The sole purpose of the entire arrangement was to reduce the Duke's exposure for surtaxes.

The Duke executed deeds with his employees (including his gardener) in which he covenanted to pay to them certain weekly sums for a period of seven years or the joint lives of the parties. The deeds recited that the payments were made in recognition of the *past services* of the retainers to the Duke and that he desired to make provision for the person notwithstanding that he may continue in the Duke's service (in which event he would be entitled to remuneration in respect of such future service) or may cease to work for the Duke.

The deed was in the following terms:

> This deed of covenant is made this fourteenth day of August one thousand nine hundred and thirty between The Most Noble Hugh Richard Arthur Duke of Westminster, D.S.O. (hereinafter called 'the Duke') of the one part.
>
> and Frank Allman of Vine Cottage Aldford near Chester, Gardener in the Duke's service (hereinafter called 'the Annuitant') of the other part.
>
> Whereas in recognition of the services which for over twenty-seven years past the Annuitant has well and faithfully rendered to the Duke the Duke desires to make provision for the Annuitant in manner hereinafter expressed notwithstanding that the Annuitant may re-engage or continue in the service of the Duke in which event he will become entitled to remuneration in respect of such future services Now this deed made in furtherance of the Duke's said desire and in consideration of the past services so rendered as aforesaid witnesses as follows:
>
> > The Duke covenants to pay to the Annuitant as from the 2nd day of August one thousand nine hundred and thirty during the joint lives of himself and of the Annuitant or for a period of seven years the weekly sum of One pound eighteen shillings (amounting in each year to the sum of Ninety-eight pounds sixteen shillings) the first of such payments having fallen to be made on the 9th day of August 1930.
> >
> > 2. The said payment shall be made from time to time on such days for such periods and in such proportions as shall from time to time be mutually agreed upon by the parties hereto and in default of agreement shall be made in weekly payments on the Saturday. of each week.
> >
> > 3. It is hereby expressly agreed that the said payments are without prejudice to such remuneration as the Annuitant will become entitled to in respect of such services (if any) as the Annuitant may hereafter render to the Duke.
> > In witness whereof the said parties to these presents have hereunto set their hands and seals the day and year first above written.

The Duke's solicitors sent each employee letters of explanation (which they acknowledged) informing them that they could claim full remuneration for future work but that it was expected in practice that they would be content with the provision made by the deed plus such sum (if any) as might be necessary to bring the total payments up to the level of the salary or wages that they had lately been receiving.

Under the applicable law of the tax years in question (1929–30 and 1931–32), the amounts paid as remuneration for services in respect of periods during which the persons were in the Duke's employ were not deductible in computing liability for surtax. If, however, the amounts were annuities, they were deductible. The legal issue was whether the annuity payments under the deeds were remuneration for services or not.

Substance or Form?

The Inland Revenue urged that the payments were in substance tantamount to wages and, therefore, substance should prevail over form. The House of Lords rejected the argument. In bona fide relationships substance depends upon the form and legal effect of the bargain, as per Warrington L.J in *In re Hinckes, Dashwood* v. *Hinckes* [1921] I Ch. 475, 489:

> It is said we must go behind the form and look at the substance…but, in order to ascertain the substance, I must look at the legal effect of the bargain which the parties have entered into.

The gardener and each of the annuitants were legally entitled to their annuity, which the payer was entitled to treat as a deduction from his total income for surtax purposes. The deeds of covenant were *bona fide*:

> 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.

Their Lordships dismissed the "so-called doctrine of substance" as "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."

Laissez Faire Economy

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be." Lord Tomlin's speech is the single most frequently quoted passage in tax law:[2]

> 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', and that here the substance of the matter is that the annuitant was serving the Duke for something equal

[2] *Inland Revenue Commissioners v. His Grace Duke of Westminster* [1936] A.C. 1 (U.K. H.L.) at page 14.

> to his former salary or wages, and that therefore while he is so serving, the annuity must be treated as salary or wages. This supposed doctrine. seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and its supposed doctrine given its quietus, the better it will be for all concerned, for the doctrine seems to involve substituting 'the incertain and crooked cord of discretion' for 'the golden and streight metwand of the law.
>
> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

The doctrine reflected the *laissez faire* economy of Britain in the 1930s.

Westminster in Canada

Canada imported the doctrine of strict literal construction from England into its common law system and applies it despite section 12 of the *Interpretation Act*, which deems every enactment to be remedial and "shall be given such fair, large and liberal construction and interpretation as best ensures the attainment of its objects".

Similarly, in *Construction of Statutes* (2nd ed. 1983), E.A. Dreidger, stated the modern rule:

> Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament (at p. 87).

However, Canadian courts interpret tax law strictly and literally on the traditional constitutional theory of parliamentary supremacy in tax legislation. Canada has also resisted non-formalist methods of interpretation partly, as the House of Lords remarked, due to the dominance of the accounting profession in Canadian tax law.[3]

> The resilience to change is only partly attributable to the influence of the *Westminster* doctrine that a taxpayer is entitled to arrange his affairs under a tax statute so as to minimize tax, regardless of the purpose of the statute. The dominance of the accounting profession, untutored in the principles of statutory construction, in tax law and legislative drafting nurtured literal and strict construction. Thus, although statutory interpretation in other areas of law shifted away from the formal to purposive interpretation, tax law was left behind as an island of literal interpretation.

Hence, the *Westminister* principle remains foundational in Canadian tax law:

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[3] *Inland Revenue Commissioners v. McGuckian* [1997] STC 908 (HL).

See, for example, *Shell Canada Limited*:[4]

> …this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect: *Continental Bank Leasing Corp. v. Canada*, [1998] 2 S.C.R. 298, at para. 21, *per* Bastarache J.

Canada v. *Antosko*, Iacobucci J., speaking for a unanimous Supreme Court:[5]

> In the absence of evidence that the transaction was a sham or an abuse of the provisions of the Act, it is not the role of the court to determine whether the transaction in question is one which renders the taxpayer deserving of a deduction. If the terms of the section are met, the taxpayer may rely on it, and it is the option of Parliament specifically to preclude further reliance in such situations.

Canada Trustco:

> Parliament intends taxpayers to take full advantage of the provisions of the Income Tax Act that confer tax benefits. Indeed, achieving the various policies that the Income Tax Act seeks to promote is dependent on taxpayers doing so.[6]

Copthorne Holdings Ltd. v. Canada ("Copthorne"):

Taxpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability.[7]

The Supreme Court has recognized that tax law serves a multiplicity of objectives other than raising revenue. Nevertheless, it rejected the proposition that it should disregard a transaction for tax purposes solely on the basis that the taxpayer transacted without an independent or *bona fide* business purpose:[8]

> Income tax legislation, such as the federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not

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[4] *Shell Canada Ltd. v. Canada* [1999] 3 SCR 622 at para 39.
[5] *Canada* v. *Antosko* [1994] 2 SCR 312.
[6] *Canada Trustco Mortgage Co. v R*, 2005 SCC 54, para 31 and endorsed in *Copthorne Holdings Ltd. v. Canada.* [2011] 3 SCR 721, para 67.
[7] *Copthorne Holdings Ltd. v Canada.* [2011] 3 SCR 721, para 65.
[8] *Stubart Investments Ltd*. v. *The Queen*, [1984] 1 SCR 536 at page 576.

> be undertaken by the taxpayer for whom the induced action would otherwise have no *bona fide* business purpose. Thus, by imposing a positive requirement that there be such *a bona fide* business purpose, a taxpayer might be barred from undertaking the very activity Parliament wishes to encourage.

In formulating interpretational guidelines, the Court said in *Stubart* that where the substance of the Act and the clause in question is contextually construed, is clear and unambiguous and there is no prohibition in the Act which embraces the taxpayer, the taxpayer shall be free to avail himself of the beneficial provision in question (at page 581), which was, in essence, a restatement of the *Westminister* principle.

Stubart was decided in 1984. Four years later, the Department of Finance enacted section 245 of the Act, the general anti-avoidance rule (GAAR), to address abusive tax arrangements that contravene the object and purpose of statutory provisions whilst complying with the technical wording of the Act.

Deans Knight Income Corp. v. Canada ("Deans Knight")[9] illustrates the application of section 245 and its intersection with statutory SAARs and the *Westminster* principle.

Canada does not generally permit consolidated financial reporting for income tax purposes. Each corporate entity is a separate taxpayer. Subsection 111(5), an anti-avoidance provision, specifically safeguards this policy and prohibits "trading" in loss corporations upon changes in corporate "control". Control is the ownership or control in law over the voting rights of such a number of the corporation's shares as entitles the owner/controller to elect a majority of the corporation's board of directors ("*de jure* control").

Deans Knight, operating under the name Forbes Medi-Tech Inc. ("Forbes"), had $90 million of unused non-capital losses, scientific research and development tax expenditures, and investment tax credits. However, it did not have income against which to offset its losses. The corporation arranged a series of complex arrangements to utilize the losses under paragraph 111(1)(a) of the Act, but without triggering the anti-avoidance loss carryover restriction in subsection 111(5).

1. Forbes moved its assets and liabilities into a new parent company, Newco.

2. Pursuant to an investment agreement, Matco purchased a debenture convertible into some of the voting shares and all the non-voting shares that Newco held in Forbes.

3. While Newco was not obliged to sell its shares to Matco, it was promised that it would receive at least a guaranteed amount if it sold the shares or if such an opportunity did not present itself.

4. Matco would find a new business venture for Forbes, which would be used to raise money through an initial public offering ("IPO").

5. The profits from the venture could be sheltered by the tax attributes (unused losses)

[9] [2023] SCC 16.

that Forbes originally could not utilize.

6. Other than when acting pursuant to the investment agreement, Newco and Forbes could not engage in a variety of activities without the consent of Matco.

7. Matco found a mutual fund management company, Deans Knight Capital Management, that agreed to use Forbes for an IPO through which it would raise money to invest in high-yield debt instruments.

8. Forbes changed its name to Deans Knight.

9. The IPO and subsequent investment business succeeded.

10. Deans Knight then deducted most of its non-capital losses to reduce its tax liability in its 2009 to 2012 tax years.

Subsection 111(5) limits "loss trading" where a corporation acquires an entity for its unused losses and rolls over the assets of a profitable corporation into it to absorb the losses.[10] The objective of the provision is to prevent financial consolidation of separate corporate entities.

Following the above series of transactions, Deans Knight transformed into a company with new assets and liabilities, new shareholders, and a new business whose only link to its prior corporate life was the tax attributes of unused losses.

1. It contracted for the ability to select Deans Knight's directors.

2. The investment agreement placed severe restrictions on the powers of the board of directors which, but for a circuit-breaker transaction that occurred, would normally occur through a unanimous shareholders agreement and which would lead to an acquisition of *de jure* control.

3. The transactions allowed Matco to reap significant financial benefits, while depriving Newco, the majority voting shareholder on paper, of each of the core rights that it could ordinarily have exercised.

The series of transactions technically satisfied the *Westminster* principle in avoiding the specific loss trading restrictions in subsection 111(5). There was no "acquisition of control" since "control" means *de jure* (legal) control.[11] However, an unrelated third party acquired the "functional equivalent" of *de jure* control by means of contractual arrangements that would not be relevant in determining *de jure* control.

The Supreme Court rejected the taxpayer's argument that "where Parliament has legislated with precision [subsection 111(5)], as here, where loss carryovers are denied in specific instances, the GAAR is not meant to play a role". Writing for the 7-1 majority, Rowe J. stated:

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[10] For example, on a tax-free rollover under subsection 85(1).

[11] *Duha Printers*, [1998] 3 CTC 303 (SCC). But now see subsection 256.1(6).

> There is no bar to applying the GAAR in situations where the Act specifies precise conditions that must be met to achieve a particular result, as with a specific anti-avoidance rule [SAAR]. As the majority recognized in Alta Energy, "[a]busive tax avoidance can also occur when an arrangement 'circumvents the application of certain provisions, such as [SAARs], in a manner that frustrates or defeats the object, spirit or purpose of those provisions'…[12]

Broadly stated, s. 111(5) is a restriction on a taxpayer's ability to make use of its non- capital losses incurred in another taxation year. Three elements of the text warrant consideration: s. 111(5)'s reference to control; its focus on an acquisition by a person or group of persons; and the continuity of business exception. The appellant argues that the object, spirit and purpose of the provision is captured by the *de jure* control test within s. 111(5). In some cases, the object, spirit and purpose may be no broader than the provision itself. However, this is only where the text fully explains the provision's underlying rationale. To determine whether this is the case for s. 111(5), the analysis must move to the context and purpose of the provision. The appellant argues that the use of the de facto control test in other provisions indicates that "Parliament ... understood the difference between de facto and *de jure* control and intended that difference". For the appellant, this is effectively determinative of the dispute [.] In my view, the context of the Act reveals that, when faced with a choice between *de jure* and de facto control as the general test, [.] there are various reasons why Parliament would have chosen the *de jure* control test as the standard [.] [I]t does not follow that the provision's rationale is fully captured by the *de jure* control test. Rather, *de jure* control was the marker that offered a roughly appropriate proxy for most circumstances with which Parliament was concerned — particularly given that the GAAR exists as a last resort. Indeed, the rationale of s. 111(5) is illuminated by related provisions which both extend and restrict the circumstances in which an [AOC] has occurred. These provisions suggest that *de jure* control is not a perfect reflection or complete explanation of the mischief that Parliament sought to address.

Deans Knight did not alter the legal test under GAAR. However, the decision illustrates that there is a risk if a taxpayer achieves an outcome highly similar ("functionally equivalent") to that at which a particular provision is directed, that it will fall within the legislative purpose of the provision and that GAAR will apply.

The Court's focus on the "abusive" nature of the arrangements, which circumvented the object, spirit, and purpose of preventing the loss trading rules that Parliament intended, reflects a shift towards purposive interpretation, at least in the context of GAAR. The *Westminster* principle was not sufficient to protect the taxpayer where it "abused" the Act.

Restrictions on Westminster

The *Westminster* doctrine, which has prevailed for 87 years, has invited increasingly complex and detailed legislation to counter tax avoidance. As each new scheme spawned to manipulate the literal language of the statute, Parliament responded with new SAARs and "comprehensive" legislation, such as the GAAR to thwart the tax planner's latest innovative schemes. In turn, the

[12] [2022] 1 C.T.C. 271 (SCC).

detail of new SAARs opened fresh opportunities for tax consultants to seize upon individual words to manipulate with literal interpretation.

There will always be some tension between a taxpayer's right to arrange her own affairs to minimize tax according to the strict legislative language of a fiscal statute and the exercise of judicial control over abusive tax avoidance that emasculates the policy of the statute. As with any maxim, the danger with the *Westminster* principle is that blanket reliance upon it can mislead taxpayers into believing that their tax plans are immune from attack. The maxim invites taxpayers to believe that they need attend only to the specific words of the Act without concern for the underlying policies of tax law.

To be sure, a taxpayer is entitled to arrange her affairs to mitigate tax in an acceptable and lawful manner. However, Finance increasingly erodes the *Westminister* principle through an increasing number of statutory anti-avoidance rules, some of which are specific, and others general. The 2023 Budget announced further proposals to strengthen purposive interpretation and weaken the *Westminster* principle through an economic substance doctrine, akin to the American approach of tax interpretation.

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