Tax Court of Canada finds corporate reorganization abuses section 84.1

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In brief

As the Tax Court of Canada pointed out in the recent decision of **Gwartz**,[1] a decision dealing with the application of the general anti-avoidance rule (GAAR), the *Income Tax Act* (the Act) does not contain any general prohibition against surplus stripping. However, transactions put in place to extract a corporation's value can be subject to specific anti-avoidance provisions, which operate to eliminate beneficial tax consequences arising from these transactions. Section 84.1 of the Act is one of those provisions. As the Court pointed out in **Gwartz**, section 84.1 'aims at precluding the stripping of corporate surpluses where shares are sold in non-arm's length transfers implemented through transaction steps [...].'[2]

In a judgment rendered on March 7, 2014, under the Informal Procedure, the Tax Court of Canada provided an example of a situation where, in the Court's view, the object and spirit of section 84.1 had been abused, triggering the application of the GAAR. Although theoretically of no precedential weight because of its status as an Informal Procedure decision, this decision is nevertheless of interest to the tax community since it provides insights into the application of this broad provision. It also raises the fundamental issue of the extent of the Minister's burden, in the GAAR context, to persuade the court that an abuse of the Act or a provision thereof has in fact occurred.

In detail

Background

The case of **Descarries**[3] involved six individual taxpayers who, in 1982, inherited 3178 common shares of a Canadian-resident corporation, Oka Inc. (Oka), from their father (or father-in-law). The deceased had held them at December 31, 1971 (V-Day). Thus, although the shares were deemed to be disposed of on the father's death at fair market value (FMV), only the portion of the capital gain that accrued after that date was taxable on the father's death due to the 'tax free zone' rules.[4]

The individual taxpayers had also acquired 820 shares of Oka from a third party for $25,000 and had subscribed for two additional shares of $100, bringing the total issued shares to 4,000.

For purposes of the matters to be considered by the Court, it was agreed that at the time of the transactions, the value of the shares was $617,466. The adjusted cost base (ACB) of the shares to the taxpayers was $361,658, which represented the combination of the FMV of the shares at the date of their

1. 2013 TCC 86.
2. *Ibid*. at para. 63.
3. 2014 CCI 75 (available only in French at the time of publication).
4. Before 1972, capital gains were not subject to tax. The so-called 'tax free zone' rules protect the portion of any capital gain that accrued before V-Day from capital gains tax.

father's death, the arm's length purchase price paid for 820 shares, and the nominal amount of $100 paid for the additional shares.

In 2004, the property held by Oka was about to be sold and the taxpayers sought tax advice on the best way to extract the proceeds. The taxpayers were made aware by their tax advisor that an extraction of value by way of simple redemption of shares would result in a significant deemed dividend (in the amount of $592,366). In other words, a high amount of tax would be payable. This was so because the shares had a low paid-up capital (PUC). Therefore, with a view to reducing these adverse tax consequences, the tax advisor recommended a plan involving a series of transactions.

Specifically, the plan consisted of the incorporation in 2004 of a new corporation, 9149-7321 Québec Inc. (NewCo), to which Oka made a loan in the amount of some $544,354. In parallel, the capital stock of Oka was modified to include class 'A' common shares and class 'B,' 'C' and 'D' preferred shares. The taxpayers' common shares were first reclassified as class 'A' common shares.

These shares were then exchanged for 617,466 preferred shares (269,618 class 'B' and 347,848 class 'C' shares) (the Internal Rollover). An election was made under subsection 85(1) of the Act, at FMV (i.e. $617,466), which resulted in a capital gain in the amount of $361,658, but also gave the taxpayers an ACB for the shares received in exchange equal to that FMV (i.e. $269,618 for the class 'B' shares and $347,848 for the class 'C' shares).

The taxpayers then transferred their shares in Oka to NewCo which, in exchange, issued 617,466 preferred shares from its capital stock (347,848 class 'A' and 269,618 class 'B' shares) (the Transfer of Shares). Paragraph 84.1(1)(a) of the Act applied to this transaction. Section 84.1 is an anti-dividend-stripping rule that, in basic terms, precludes a step-up in PUC where shares are transferred in a non-arm's length transaction.

In such a transfer, the transferor may receive shares with a PUC equal to the ACB of the transferred shares to the taxpayer, but for this purpose, ACB is determined in accordance with a special rule that reduces ACB by any gain of the taxpayer or a non-arm's length prior holder that was protected by the V-Day value or the capital gains exemption, and by certain tax-free dividends declared on the shares.

In other words, the tax-free zone provides protection from a capital gain when there is a transfer of the shares from one taxpayer to another, as in the case of the transfer of the Oka shares to the taxpayers on their father's death, but does not facilitate a distribution by the corporation of value that accrued prior to V-Day unless there has been an arm's length transfer of the shares.

Since the initial Oka shares, and therefore the substituted shares, had a V-Day value that had sheltered part of the taxpayers' father's capital gain from tax, and tax-free dividends had also been declared on those shares, the PUC of the class 'B' shares in NewCo was reduced considerably. The PUC of the class 'A' shares was equal to their ACB and redemption amount.

NewCo immediately redeemed the 347,838 class 'A' preferred shares and 196,506 of the class 'B' shares, for total redemption proceeds of $544,354 (i.e. the amount loaned to NewCo by Oka). The remaining 73,112 class 'B' shares were redeemed in 2008. Since the PUC of the class 'B' shares had been reduced by the application of 84.1, deemed dividends in the total amount of $264,506 arose from the redemptions.

The redemptions also had the effect of creating capital losses of roughly the same amount ($268,618), as a result of the deemed dividend and the high ACB of the class 'B' shares. The capital losses were used to offset entirely the capital gain that had resulted from the Internal Rollover. In the meantime, resolutions were adopted by Oka's and NewCo's boards of directors and Oka was wound up into NewCo. As a consequence, the debt between Oka and 9149 was extinguished. Oka was later dissolved.

In sum, by way of these transactions, the taxpayers extracted the entire value of Oka, in the amount of $617,466, and were taxed on a deemed dividend of only $264,506. The Minister reassessed the taxpayers and included an increased deemed dividend, in the total amount of $592,366, that is, the deemed dividend that would have arisen from a simple redemption of shares.

At the Tax Court, the Minister first relied on subsection 84(2) and contended that the redemptions constituted a distribution of funds or property of Oka, 'on the winding-up, discontinuance or reorganization of its business,' resulting in a deemed dividend of $592,366. Alternatively, the Minister invoked the general anti-avoidance rule (GAAR) contained in section 245 of the Act and argued that the transactions ran counter to the object and spirit of subsection 84(2).

TCC's decision

Subsection 84(2) does not apply

The Minister's first argument was rejected by the Tax Court. Based on the decisions of **MacDonald**,[5] **Merritt**[6] and **McNichol**,[7] the Court, per Hogan J, found that for a 'distribution' to occur, there has to be not only a gain for the shareholder, but also a loss from the corporation's point of view. Hogan J decided that it was not the case in the circumstances. Oka was not impoverished at the time the redemptions took place in 2005 and 2008.

When Oka made the loan to NewCo in 2004, its cash was replaced by a receivable: the overall assets of Oka therefore remained unchanged. This remained the situation at the time of the redemptions. Further, Hogan J compared the taxpayers' situation to that of the taxpayers in **McNichol**, in which the Court found that no distribution had occurred because payment for the shares was made out of a bank loan, and not from the corporation's funds. Hogan J also added that Oka's assets had been reduced only on December 15, 2006, when the loan was extinguished as a result of the liquidation.

Additionally, the Court stated that the winding-up, discontinuance or reorganization of the business would have to be contemporaneous with the distribution for the conditions of subsection 84(2) to be met. The Court found that this was not the case in the appeal in question because the first redemption occurred in 2005, while Oka continued its operations until December 2006.[8] The Court also pointed out that the Minister's position was ill-founded, since it would amount to both subsections 84(2) and 84(3) being applicable contemporaneously.[9]

Section 245 applies in the context of 84.1

The Court then went on to examine the Minister's alternative position, i.e. the application of the GAAR. The Appellants acknowledged that there was an avoidance transaction, thus leaving the Court with only one issue to decide, that is, whether the avoidance transactions were abusive under subsection 245(4) of the Act. To do so, the Court first needed to analyze the object and spirit of subsection 84(2), which the Minister contended had been abused. At this point, Hogan J. quoted from Hershfield J's reasoning in the case of **MacDonald**,[10] in which the Minister had essentially advanced the same arguments.

Like Hershfield J, Hogan J rejected the Minister's argument according to which subsection 84(2) 'was, and remains, an anti-avoidance provision the language of which must be construed more broadly to ensure dividend treatment when a taxpayer indirectly receives the retained earnings of a company that he was entitled to receive as a shareholder.'[11]

Hogan J reiterated the conclusion he arrived at in **Gwartz**: the Act contains no general rule that every distribution by a corporation must be by way of dividend. However, Hogan J also emphasized, as he did in **Gwartz**, that although a corporation may distribute via dividend or capital gain, such distributions are not without limits. All distribution plans must comply with the anti-avoidance rules contained, *inter alia*, in sections 84.1 and 212.1 of the Act.

The Minister apparently did not initially invoke section 84.1 in support of its GAAR arguments.[12] Hogan J indicates that after receiving the initial written submissions of both parties, he himself asked the parties to provide submissions with respect to the abuse of section 84.1. In Hogan J's view, this way of proceeding did not prejudice the taxpayers, since they had had the opportunity to submit written submissions on the matter.

Hogan J also noted that the taxpayers' tax advisor had discussed section 84.1 in a memorandum discussing the notion of 'abuse' contained in subsection 245(4). Hogan J therefore rejected the taxpayers' argument that the appeal should be granted since the Minister had not fulfilled its burden of proof regarding the question of abuse. On this point, Hogan J stated that, in his view, the expression 'burden of persuasion,' a notion applicable to questions of law, would be more appropriate than 'burden of proof.'

5. 2012 TCC 123 [**MacDonald** TCC] and 2013 FCA 110.
6. [1941] Ex. C.R. 175, at paras 4-7 and [1942] S.C.R. 269, at p. 274.
7. [1997] 2 C.T.C. 2088.
8. Evidence at trial showed that Oka sold the property it held in 2005 and was, until December 2006, involved in a court action.
9. Of note is the fact that the Court specified that the rule of precedence contained in subsection 84(2) was not applicable in the circumstances, since the redemptions and the distribution of funds were made by two different corporations.
10. **MacDonald** TCC, supra, note 5, at paras 63-69 and 128. The decision in this case was reversed but on the basis that subsection 84(2) applied, not because the GAAR applied.
11. *Ibid.*, at para. 63.
12. The Reply to the Notice of Appeal does very briefly mention, at paragraph 52, the Minister's position that section 84.1 had been abused, but counsel seemingly did not make representations to this effect at trial.

On the other hand, Hogan J agreed with the taxpayers that the Minister 'would do well' to describe the object and spirit of the provisions he feels the transactions run afoul of. In this respect, he emphasized that the principle remained that if the Court is not convinced that there was an abuse, the taxpayer will be given the 'benefit of the doubt.'

Hogan J then went on to examine section 84.1. He found that the object and spirit of the provisions contained in paragraphs 84.1(2)(a), 84.1(2)(a.1) and subsection 84.1(2.01) is to prevent the taxpayer from setting up transactions to strip a corporation's surplus on a tax-free basis, using the value accrued on the shares prior to January 1, 1972, or the capital gains exemption. This object and spirit, Hogan J found, was in line with comments the Minister of Finance had made in respect of the purpose of section 84.1 when, following the introduction of the capital gains exemption, proposed modifications to section 84.1 were introduced.

In the Court's view, the transactions in question ran afoul of this purpose and spirit. Indeed, stated the Court, the taxpayers' advisor was well aware of the fact that a simple redemption of shares would result in a taxable dividend in the amount of $592,366 and in a capital loss in the amount of $336,558. The Internal Rollover was therefore put in place with the specific intention to bump the ACB of the shares.

According to Hogan J, the tax advisor was also well aware that the V-Day value would ensure that the PUC of the class 'B' shares would be reduced to an amount lower than the ACB, through the application of section 84.1 and paragraph 84.1(2)(a.1). This would ensure the creation of a capital loss in an amount great enough to eliminate the capital gain realized on the Internal Rollover.

In other words, Hogan J held that the V-Day value was used to indirectly distribute a portion of Oka's surplus on a tax-free basis. Thus, the Internal Rollover of the shares of Oka, the Transfer of Shares of Oka to NewCo and the redemptions of shares in NewCo permitted the distribution of a portion of Oka's surplus to the taxpayers in such a way as to contravene the object and spirit of section 84.1. As such, section 84.1 had been abused. Although he made some adjustments to the Minister's calculation of the deemed dividend resulting in the Appeals being granted in part, on the whole, the taxpayers lost.

Broader implications

As mentioned, this decision is of interest to the tax community, as it offers some insight as to how the GAAR may be interpreted, in the specific context of section 84.1.

While this decision was rendered under the Tax Court of Canada's Informal Procedure and is therefore not precedential, decisions and reasoning from Informal Procedure judgments are still often taken up and reiterated by later decisions under the General Procedure.

Of equal interest are Hogan J's comments regarding the Minister's 'burden of persuasion,' as distinct from a 'burden of proof.' By raising the abuse of section 84.1 without the Minister having argued it in the first instance, the court essentially discharged the Minister of a real burden. We would respectfully suggest that the Minister's burden of establishing abuse of a provision of the Act is indeed a real burden and should not be taken lightly.

The 30-day limit to appeal the Tax Court's decision to the Federal Court of Appeal ends on April 7, 2014. At the time of publication, the taxpayers had not yet appealed the decision. However, since the decision was rendered under the Informal Procedure, the grounds for a possible appeal are significantly restricted.[13]

13. As provided in subsections 27(1.2) and 27(1.3) of the *Federal Courts Act*.

Let's talk

For a deeper discussion of how these issues might affect you or your business, please contact:

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