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Capital Gains Taxed Twice

101139810 Saskatchewan Ltd. v. The Queen (**2017 TCC 3**) is a timely reminder of the potentially harsh consequences of subsection 55(2) and the need to exercise caution in any planning involving actual or deemed intercorporate dividends. The events in *101139810* occurred in 2009, before the recent amendments to subsection 55(2), but the reasoning in the case remains relevant today.

A Canadian corporation (8231) held 34 shares worth $2.6 million in another Canadian corporation, CSM. In 2009, 8231 and its sole owner (Mr. C) entered into a reorganization to enable Mr. C to personally claim a capital gains deduction under section 110.6 on an indirect sale of the 34 CSM shares to two CSM shareholders unrelated to 8231. To facilitate this transaction, the 34 CSM shares were spun out to two new Holdcos (9810 and 9807) solely owned by Mr. C before the sale, and the following steps were taken:

- 8231 transferred 17 CSM shares to 9810 and 17 CSM shares to 9807 on a fully tax-deferred basis under subsection 85(1). As consideration, 8231 took back shares worth $1.3 million from each of 9810 and 9807.
- Mr. C transferred shares in 8231 worth $1.3 million to each of 9810 and 9807 on a fully tax-deferred basis. As consideration, Mr. C took back shares from each of 9810 and 9807.
- The shares transferred between 9810 and 8231 were cross-redeemed by causing each corporation to issue to the other a $1.3 million promissory note, which were subsequently offset. The same occurred for the shares transferred between 9807 and 8231.

Mr. C then sold 9810 and 9807 to the two purchasers for $2.6 million in aggregate, giving rise to a $2.6 million capital gain on which Mr. C claimed his available section 110.6 deduction of $0.2 million.

As a result of the share redemptions, 9810, 9807, and 8231 each reported a subsection 84(3) deemed dividend and an offsetting dividend deduction under subsection 112(1). However, because the reorganization and the subsequent sale were part of the same series, there was no dispute that the exception in paragraph 55(3)(a) was inapplicable. The primary issue to be decided was whether subsection 55(2) recharacterized the $1.3 million deemed dividend received by each of 9810 and 9807 as capital gains. The minister initially reassessed 8231 on the same basis but vacated that reassessment prior to reassessing 9810 and 9807.

The taxpayers argued that subsection 55(2) should not apply because no significant reduction in capital gains resulted from the deemed dividends (for subsection 84(3) deemed dividends, the relevant test is the "result" test). Although

the deemed dividends fully eliminated 9810's and 9807's proceeds of disposition, no capital gain was avoided when the transactions were considered in the aggregate, because Mr. C actually incurred $2.6 million of capital gains afterwards. If subsection 55(2) were to apply, the taxpayer argued, it would exceed its scope as an anti-avoidance provision and would lead to double and potentially triple taxation.

The court examined the wording of subsection 55(2) and found it clear that the phrase "a significant reduction in the portion of the capital gain" refers to the dividend recipient corporation's capital gain because of references to that corporation before and after that phrase. The court also pointed out that the phrase clearly refers to a notional capital gain occurring immediately before the dividend as opposed to an actual gain occurring afterward. Therefore, the court found that a plain reading of subsection 55(2) does not permit the consideration of an actual capital gain realized subsequently by another entity in place of the dividend recipient corporation, especially when the other entity is an individual. The court also undertook a purposive analysis and concluded that 9810 and 9807 "walked right into" a situation to which Parliament intended the subsection to apply, since it was "incumbent" on the taxpayers to ensure that they met the exceptions to subsection 55(2).

The court also discussed whether the application of subsection 55(2) offended the general policy of preventing double taxation. The recharacterization caused the value of the CSM shares to be taxed in 9810's and 9807's hands and again in the hands of Mr. C. After reviewing relevant jurisprudence on the subject, the court concluded that there was no double taxation because the same taxpayer was not subject to tax twice on the same amount.

This case was probably decided correctly. The fact that the relevant test is the "result" test leaves little room for interpretation when a redemption has indeed significantly reduced a notional capital gain. Although it is debatable whether the court's narrow interpretation of the double taxation policy is fair, it is not likely that even a finding of double taxation could have prevented the application of subsection 55(2) when a transaction fell squarely under the provision.

Although subsection 248(28) was not mentioned in the judgment, that provision would not have been helpful because it also applies only in the case of double taxation of the same taxpayer. It is interesting that the minister vacated the subsection 55(2) reassessment against 8231, because that would have resulted in the same value being taxed three times; it is anyone's guess whether *101139810* would have been decided differently if that were the case.

The taxpayers brought up *729658 Alberta Ltd. v. The Queen* (**2004 TCC 474**) in their argument, but in my view that decision has little bearing on *101139810*: the issue in *729658* was the determination of how much accrued gain should "reasonably" be apportioned to safe income, which is a different issue from the issue in *101139810*.

Apart from its value as a cautionary tale, the decision in *101139810* could call into question some of the CRA's recent views on the application of GAAR to transactions that rely on share redemptions and paragraph 55(3)(a) to avoid the

broad reach of the new subsection 55(2)—for example, TI 2015-0604521E5 (January 13, 2016): if failing to meet paragraph 55(3)(a) could result in the same amount being taxed twice as capital gains, then why would complying with paragraph 55(3)(a) to prevent the acceleration of gain recognition be a misuse or abuse of the Act?

Kenneth Keung
Moodys Gartner Tax Law LLP
Calgary

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