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Taxpayer Victories: Coincidence or Trend?

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It is relatively infrequent that most tax advisors – much less their clients – have close encounters with Canada's tax courts. But tax cases can ultimately permeate the environment that taxpayers face. If tax decisions go favourably for the CRA – as has recently often been the case for upper-level courts, anyway - the CRA will ultimately be more aggressive in dealing with taxpayers. That's why I'm concerned about recent tax decisions, particularly those emanating from our top courts. Actually, it's not just that cases are going against taxpayers - it's that they deal with commonplace situations. The penultimate GAAR verdict from the Supreme Court struck down a simple "spousal flip", where a wife borrowed money to buy shares of a family company from her husband (*Lipson*). The most recent GAAR decision by the top court (*Copthorne*) isn't that much more complicated – striking down a scheme that turned a vertical amalgamation to a horizontal merger, to preserve the tax-attributes of pre-existing share capital (OK, it was a double count, but hopefully you get my drift).

Practitioners are left to ask – if these transaction are offensive what isn't – particularly in the eyes of the CRA? But in recent weeks, there's been (dare we say) a glimmer of hope – emerging from three Tax Court of Canada verdicts, in which the tax court rejected CRA arguments and upheld taxpayers claims.

MacDonald – Pipelines Trashed

The first case I will deal with, *MacDonald* v. *The Queen* (2012 TCC 123), involved a physician with a capital loss balance moving to the States. The plan involved utilizing this balance by selling his shares in a investment-rich company to a relative for a promissory note. Although the actual facts were more complicated, in essence the relative transferred the company to a holdco for a back-to-back note, which allowed the taxpayer's former company to strip out cash by paying tax-free dividends to holdco, and ultimately the taxpayer's redeeming his note without tax. If the structure rings a bell, it's very similar to a post-mortem "pipeline" transaction that is commonly employed to utilize the cost base in shares of a private company occasioned by "death tax", to access assets from the company. And like a pipeline, the CRA marshaled subsection 84(2) to attack the structure – an arcane provision which was brought in well over half a century ago, when the lack of capital gain tax was used by aggressive taxpayers to avoid tax on dividends. (It potentially applies where funds or property of a corporation have been distributed or otherwise appropriated in any manner whatever to or for the benefit of shareholders of any class on the winding-up, discontinuance, or reorganization of its business.)

But Hershfeld J was having none of it. The judge held that the way the transaction was structured, Dr. MacDonald drew the money out as a creditor, not a shareholder as required by provision, so that it did not apply. Hershfeld J considered earlier cases on subsection 84(2) in the light of post-71 changes to the Act in respect of surplus strips (section 247, replaced in 1988 by GAAR) and concluded that subsection 84(2) should be construed strictly (as the Tax Court of Canada had done in *McNichol* (97 DTC 111)).

As I said, the CRA has been trotting out this provision in post-mortem "pipelines", which involve the estate of a decedent transferring shares of an Opco to a holdco for debt in order to extract corporate-level assets equivalent to the cost base of the Opco shares, which is bumped up when the shares pass on death to another generation – i.e., by Opco paying the holdco tax-free dividends and repaying the holdco debt owing to the estate. Of course, the key benefit that attracts tax planners - and has provoked ire on the part of the CRA - is that corporate assets can be accessed at the lower rates applying to capital gains (i.e., due to death tax), rather than dividends. In fact, the week the case came down, no less than two Rulings by obviously intimidated taxpayers were released by the CRA.

But just as Obama poured cold water over the Keystone XL pipeline, the *MacDonald* case did much the same thing with the CRA's contention that subsection 84(2) applies to pipelines, pointing out that the conditions imposed by the CRA for a favourable ruling were "clearly arbitrary" and "not invited by the express language in subsection 84(2)" (see par. 80). Where GAAR would not apply to re-characterize the legal effect of a series of transactions, other provisions should not be too readily stretched to give that result where a strict reading of them does not invite such result (paragraph. 82).

As for GAAR, the judge did not find the structure abusive (one of three pre-requisites for the application of GAAR). The departure from Canada would have triggered the very same capital gain realized on the share sale thereby ensuring reconciliation of his capital gains and losses. Therefore "to deny a tax benefit to which he was entitled by an express provision of the *Act* because he achieved it by a different legally effective means is, frankly, bizarre" - although the judge shortly afterward conceded that "bizarre" might be putting it too strongly, as the real concern of the CRA is about surplus strips (see par. 121 and 122). In that regard, the judge later observed that the tax benefit is "systemic" (i.e., between "pipeline-type" methods relying on capital gains rather than dividend rates to extract corporate-level surplus); accordingly, neither GAAR nor subsection 84(2) can be used to fill a gap between the approaches and prevent a tax-planned approach to accessing retained earnings (see par. 132).

Personally, I glad I wasn't in the same room with CRA officials when the *MacDonald* case came out; I am quite sure they are not looking forward to the inevitable barrage of questions at the upcoming CRA round table sessions at various tax conferences.

McClarty: Transmogrification, and Non-tax Purpose

McClarty Family Trust (2012 TCC 80) involved a scheme to transmogrify dividends from a family company – which would be subject to the "kiddie" tax – to capital gains, which at the time of the transactions were not (see below). The structure has long been high on the CRA's GAAR radar screen, because it has been all the rage, particularly with taxpayers in western Canada. In its general incarnation, a high-low stock dividend would be declared on shares of a family company held by a family trust, to shift equity value to the stock dividend shares. Like the standard plan, these shares were sold from the family trust to Mr. McClarty – resulting in a capital gain, which was then distributed to the trust's three minor beneficiaries. The stock dividend shares were sold to a holding company and subsequently redeemed tax-free. By virtue of the structure/variants, amounts owing by Mr. McLarty to the family trust were built up (along with amounts owing from the family trust to the minor beneficiaries). The Judge rejected the application of GAAR (i.e., the re-characterization sought by the CRA - of the trust's/beneficiaries' capital gains as dividends): given that the series transaction was motivated by creditor protection, he held that it wasn't an "avoidance transaction" - one of three GAAR pre-requisites, voicing the view that every single transaction was made with a bona fide purpose other than to obtain a tax benefit (par. 52). (Based on precedent, the court rejected the CRA's argument that the structure was an avoidance transaction because the creditor-proofing objective could be achieved in a less tax-efficient manner.) Although there was no need to determine whether the transaction was abusive - the final GAAR pre-requisite - the court noted that there was a gap in the "kiddie" tax for this sort of transaction, but it is inappropriate to use GAAR to fill a gap left by Parliament (pars. 54 and 55).

Indeed - taxpayers (other than those who are facing CRA scrutiny over similar structures) will find the actual tax strategies under review in this case mainly of historical significance: The 2011 federal Budget filled the gap - nixing this type of structure - by expanding the tax on split income (i.e., the "kiddie" tax) to encompass capital gains included in the income of a minor from a disposition (after March 21st, 2011) of shares of a corporation to a non-arm's length person, if taxable dividends on such shares would have been subject to the tax on split income. But the case is relevant to tax planners because it shows that, when it comes to GAAR, a non-tax purpose can save the day.

Dhaliwal – what's an election, anyway?

The final case, *Dhaliwal* (2012 TCC 84), involved a claim for an allowable business investment loss (ABIL) on a bad debt. Needless to say, the CRA sent out its usual questionnaire; but although there were a few twists, they were ultimately not a problem.

The interesting issue centered around the requirement that, for ABIL treatment to apply to bad debts and shares of bankrupt corporations and the like, the legislation (subsection 50(1)) requires the taxpayer to *elect in the taxpayer's tax return for the year*. The CRA envisions a letter filed with the return (as the court noted, there is no prescribed or recommended form). Trouble is, with electronic filing, this is not possible – i.e., *in* the return itself - as the *Income Tax Act* requires. So the issue was whether reporting the *tax results* of the ABIL (i.e., that the ABIL was deducted against ordinary income, etc.) meets the tax act requirement for an "election". Not only did Boyle J find that this was Kosher[1], but he trashed the CRA's submissions (among others, to separately mail in an election or that the *Income Tax Act* simply does not allow an e-filer to make the election).

But an issue is how far the decision goes. It seems to me that although the judge was motivated by the constraints of e-filing, the decision may be interpreted to extend to paper filings as well (see paragraph 34 of the case - although the lawyer in me is screaming "do a letter"). But what about tax act sections with similar requirements? Although much of the case focuses on the history of ABIL claims in subsection 50(1) of the Income Tax Act, it is arguable that the reasoning similar to *Dhaliwal* may apply to at least some similarly-worded elections[2] (but see "screaming lawyer remark", above). But Boyle J stressed that the subsection 50(1) requirement is that the election be "in" the tax return, not "with" the tax return (see par. 30). A good example of the latter is the election not to have the capital gains attribution rules apply for separated "spouses": paragraph 74.5(3)(b) not only requires that the election be filed "with" the return, but "jointly" by the former couple.

So are these three cases signs that the courts are giving the CRA pushback, or are they a just a happy coincidence? Mind you, they are all lower court cases. But I see a common thread to these cases: they do not involve fortunes, but the CRA was coming at the taxpayers with both barrels[3]. Maybe it's just my imagination, but could some tax court judges be a tad steamed at CRA aggressiveness?

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[1] Per paragraph 34: "it is sufficient to communicate the taxpayer's election by clearly communicating in his or her tax return that he or she wants to be allowed an ABIL in respect of particular debt or shares disposed of in that year."

[2] Consider, for example, the elections referred to in subsection 14(1.01) and paragraph 249(4)(c) (the 7 day year-end extension upon an acquisition of control). However, the election to opt out of the subsection 73(1) rollover has ramifications to a spouse or common law partner (e.g., see subsection 74.5(1)), but it may not be clear whether a "results-based" election has been made (e.g., if there has been no appreciation of the transferred property); consider also subsection 87(3.1) (tracking of PUC through an amalgamation), and the various replacement property rules. Subsection 256(9) provides that control is deemed to be acquired at the beginning of the day *unless* the corporation otherwise elects. I am not persuaded that provisions with similar wording to that considered in *Dhaliwal* should necessarily give rise to that same result.

[3] For example, besides the *MacDonald* subsection 84(2) argument, in *McClarty,* an "abutting" provision (subsection 84(3)) was argued by the CRA with a similar outcome.