Accessing Surplus: What Works, What Doesn't, What's Left

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Introduction

Accessing corporate surplus and "surplus stripping" have been the topic of numerous articles and conference papers published by the Canadian Tax Foundation. [1] The authors do not purport to have improved on this scholarship, but instead seek to re-examine the policy rationale for the concerns with surplus stripping, and to examine whether the surplus stripping jurisprudence has developed to the point that general principles can be identified that may form the basis for assessing the technical and general anti-avoidance rule ("**GAAR**") risks associated with particular types of plans.

While the authors share the opinion expressed in the jurisprudence that there is no "scheme" of the Income Tax Act [2] relating to "surplus stripping" - the correctness of this position becomes apparent when one considers the issues in defining "surplus stripping" - there is obviously a concern from a policy standpoint. On a practical level, the challenge for practitioners and the Canada Revenue Agency (the "**CRA**") is to identify arrangements that achieve a tax-efficient distribution of corporate surplus without engaging one or more specific anti-avoidance rules or the GAAR.

This paper is divided into four parts. First, the authors will frame surplus stripping as a policy issue, and will explore alternative means of addressing this issue. Second, a brief history of the legislative approaches to combating surplus stripping will be provided. Third, the authors will review the jurisprudence relating to the application of specific anti-avoidance rules and the GAAR to surplus stripping arrangements in a search for principles that can be applied in evaluating future arrangements. Finally, the authors will examine some popular planning options and consider the efficacy of these options in light of the principles divined from the jurisprudence and the CRA's administrative pronouncements.

Surplus Stripping - Policy Concerns and Alternatives

Definition and Policy Concerns

In order to properly identify and discuss the merits of arrangements that may involve surplus stripping, it is first necessary to understand the mischief and to understand the tax policy objectives that are frustrated by this mischief. Armed with this knowledge, it is possible to question not only the merits of creative tax plans, but also the wisdom of the current legislative approach to taxing corporations and their shareholders while preventing the identified mischief.

The task of defining a colloquial term like "surplus stripping" is made somewhat challenging by the evolution of the term in response to a changing legislative and jurisprudential environment. That is, because of fundamental changes to the Canadian income tax landscape occurring subsequent to the origin of this phrase, surplus stripping has evolved from describing only transactions that avoid shareholder-level tax entirely to including transactions that achieve a capital gain vs. dividend rate arbitrage at the shareholder level and, in some cases, transactions involving the creation or trafficking in tax attributes for the purpose of extracting corporate surplus.

Like most tax policy discussions undertaken by Canadian tax practitioners, the starting point in defining surplus stripping is the report of the Carter Commission. [3] The Commission was asked by the Department of Finance to prepare a study on surplus stripping, and a thorough discussion is contained in the report. In describing the problem that was being considered, the following definition was adopted:

> The term surplus-stripping is usually applied to situations where there is an actual distribution of accumulated corporate income and tax thereon is avoided by legal but artificial means. In the original version the shareholder realized on the accumulated income by a tax-free sale of shares, while the actual distribution went tax free to another corporation set up for the purpose and could be applied by it toward the purchase price of the shares. [4]
> [Emphasis Added]

At the time that the Carter Commission report was published, capital gains were not taxed in Canada, while dividend income was subject to tax (albeit at a rate that gave some credit for the underlying corporate income tax). As a result, surplus stripping was an all or nothing undertaking by taxpayers: accessing the corporate surplus through the realization of a capital gain would completely eliminate shareholder level income tax, while paying a dividend would result in personal income tax at rates that were not perfectly integrated.

As part of the 1971 tax reform initiative, capital gains became subject to tax at a preferred rate and corporate and shareholder level income tax generally became better integrated. [5] As a result, simply converting a dividend to a capital gain did not completely eliminate the shareholder level income tax, but rather created an opportunity for rate arbitrage. However, the introduction of special rules relating to V-Day value and the distribution of 1971 surplus did preserve limited opportunities for a complete elimination of shareholder level income tax. Reflecting this change, definitions of surplus stripping used after the 1971 tax reform focused more on rate arbitrage than complete tax avoidance. [6]

The introduction of the lifetime capital gains exemption (now the capital gains deduction) in 1985 upped the ante for surplus stripping by creating the opportunity for up to $500,000 of capital gains to be exempt from tax. The potential for surplus stripping to once again result in a tax-free distribution had an immediate impact on how surplus stripping was conceptualized, with the scope of surplus stripping now encompassing transactions resulting in both tax-free and tax-favourable distributions. [7] However, as noted by H. Heward Stikeman and Robert Couzin in their seminal manuscript on this topic, the core of surplus stripping remained the conversion of dividends to capital gains:

> Surplus stripping is considered to occur when a shareholder takes a shortcut in accessing accumulated surplus of a corporation. This has generally meant choosing to realize the economic value of such surplus through a transaction characterized as a sale of shares that gives rise to a capital gain, rather than a distribution from the corporation that is taxed as a dividend. [8]

Although this definition of surplus stripping necessarily encompasses the creation of capital gains for the purposes of rate arbitrage rather than a complete avoidance of tax as was the case in 1966, the core feature of surplus stripping - the substitution of a capital gain for a taxable dividend - remained unchanged from 1966.

The broadening of the surplus stripping concept has mostly occurred subsequent to 1995, primarily as the result of the CRA labelling transactions as surplus strips where the core feature of the arrangement is not the substitution of a dividend for a capital gain. Examples have included income-splitting with children, [9] the creation of paid-up capital ("**PUC**") using property owned by a shareholder, [10] the duplication of PUC, [11] and the sale of a business. [12] In these cases, while the surplus of the corporations may have been accessed, one of three features applies to distinguish the transactions from traditional surplus stripping. Either: (a) the reason for the accessing of the surplus was not to avoid the payment of a dividend; (b) the outcome of the transactions was not the creation of a capital gain; or (c) the substitution of the capital gain for a dividend was not the reason why the transactions were tax-effective.

Given the seemingly overbroad use of the term surplus stripping, it is unsurprising that the CRA has been unsuccessful in proving that there is a scheme of the Act relating to surplus stripping in the GAAR decisions where this issue has been raised. If there were such a scheme of the Act, and the CRA's imprecise definition of surplus stripping were to be applied, all value extracted from a corporation that is attributable to its surplus would only be extractable as a dividend. Transactions which could be described as surplus strips, such as a decision to sell shares of a corporation with accumulated retained earnings without first paying a dividend, could attract the application of the GAAR.[13] It is therefore unsurprising that the courts have declined the CRA's invitation to confirm the existence of such a scheme.

In this paper, the authors will adopt the same definition of surplus stripping as was favoured by Stikeman and Couzin, and which generally uses the term surplus stripping in a manner in which it would have been understood in 1966. The discussion of jurisprudence and planning alternatives will consider cases and arrangements where the intended tax benefit is a product of the substitution of a capital gain, whether taxed or non-taxed, for a taxable dividend.

Policy Rationale

The basic tax policy issue that is created by surplus stripping is reasonably obvious. The rates of corporate income tax and personal income tax on dividends are (at the federal level) designed together to achieve the integration, such that the rate of combined shareholder-corporate income tax on distributed profits closely approximates the rate of tax that would be payable had an individual shareholder earned those profits directly. This is an example of the neutrality principle that underlies Canadian income tax law.

Under the Canadian integration system, corporate business profits are taxed at a rate that is significantly less than the top marginal rate.[14] When dividends are paid, a grossed-up amount is included in the income of the shareholder pursuant to subsection 82(1), with the amount of the gross-up depending on the rate of income tax paid by the corporation. An amount approximating the corporate income tax on the grossed-up income is then deducted from the shareholder's tax payable under section 121. In theory, the net shareholder level income tax payable on the dividend plus the corporate tax already paid should equal the personal income tax that would be have been paid on an equivalent amount of business income earned by an individual directly.

In practice, however, integration is not perfect. First, as noted by Stikeman and Couzin, the imposition of corporate income tax at a rate that is lower than the personal income tax rate results in an opportunity to defer the portion of the integrated corporate-shareholder income tax that is collected from the shareholder when a divided is paid.[15] Second, each of the provinces imposes its own corporate and personal income taxes and provides (or does not provide) an equivalent dividend tax credit; if the province over-credits or under-credits the shareholder when a dividend is received, the result may be non-neutral.

Having regard for the foregoing, it is apparent that a shareholder who is able to receive a distribution of the previously-taxed business profits of a corporation at a rate that is less than the rate of tax on dividends paid from those profits is achieving a result that is better than the integrated tax result desired by Parliament. Combined with the potential to deferral the personal income tax on business profits earned by the corporation, surplus stripping offers the potential for persons carrying on business through corporations to achieve tax results that are significantly better than the tax results that would be realized if business were carried on directly, thereby frustrating the neutrality principle upon which integration is based.

Of course, the policy rationale for the multitude of provisions supporting the integration regime or preventing surplus stripping is not quite so simple. Consideration must be given to anti-deferral measures, tax incentive measures and provincial tax policy in order to have more fulsome understanding of the competing forces at play.

First, Parliament has recognized the deferral opportunity described by Stikeman and Couzin as creating the potential for a non-neutral result where portfolio investment income is earned by a closely-held corporation. In order to limit the benefits associated with these "incorporated pocketbooks" for Canadian-controlled private corporations ("**CCPCs**"), Canada has adopted an anti-deferral regime for CCPC investment income that causes corporate income tax to become payable on this investment income at a rate approximating the integrated corporate-shareholder income tax rate, with some of the tax refunded to the corporation when dividends are paid to the shareholder.[16]

There is one complication and one benefit arising from the existence this anti-deferral regime. As a complication, the rate of corporate income tax on this investment income, both before and after the refund of refundable tax, is different rate than the rate of corporate income tax on business profits, and the rate of personal income tax on dividends paid from this investment income is different than the rate of personal income tax on dividend paid from business profits. As a benefit, there is no advantage to surplus stripping transactions where a CCPC earns investment income, since the shareholders should be better off receiving dividends.

Second, Parliament has enacted two significant tax preferences for CCPCs and their shareholders that contribute to the attractiveness of surplus stripping. As a result of the small business deduction in subsection 125(1), the rate of corporate income tax paid by a CCPC on its first $500,000 of business profits is significantly lower than the general corporate income tax rate, with a corresponding increase in both the personal income tax payable when a dividend is paid and the amount of personal income tax deferred when profits are retained by the corporation. The effective rate of personal income tax on these dividends is always higher than the effective rate of personal income tax on capital gains, and usually by a significant margin, creating a meaningful incentive for taxpayers to engage in surplus stripping.

The impact of the second such tax preference, the capital gains deduction, was alluded to above. Section 110.6 permits shareholders to receive up to $800,000 (indexed for inflation) tax-free on a disposition of shares in the capital stock of a qualified small business corporation, family farm corporation or family fishing corporation. Preventing taxpayers from using the capital gains deduction to extract surplus on a tax-free basis is one of the main reasons why subsection 84.1(1) is needed, as the surplus stripping potential of the capital gains deduction is obvious.

Third, the provinces do not impose tax on corporate income at uniform rates, nor do they impose personal income tax on dividends and uniform rates and provide uniform dividend tax credits. This creates a significant variation in the attractiveness of surplus stripping transactions as between similarly situated taxpayers in different provinces. For example, the combined top marginal rates on capital gains and eligible dividends in Alberta are 19.50% and 19.29%, respectively, creating a slight preference for eligible dividends, but one which is not large enough to justify any planning in most instances. In contrast, the combined top marginal rates on capital gains and eligible dividends in Manitoba are 23.20% and 32.26%, respectively, creating a strong preference for capital gains and a strong incentive for surplus stripping.

Policy Alternatives

Eliminating Corporate Income Taxes

It is well understood that corporate taxes are ultimately borne by individuals, since corporations, despite their legal personality, are essentially conduits through which income passes to individuals. [17] As a result, it can be difficult to justify the taxation of corporations on a current basis as a tax on benefits (such as the preservation of property rights) enjoyed by the corporation, since these benefits are actually collectively enjoyed by the shareholders. There is also some evidence that the cost of corporate income tax in a small open economy like Canada's may ultimately be borne by the owners of natural resources or by labour and not the shareholders of the corporation. [18]

The most compelling rationale for levying corporate income tax is that it serves as a form of withholding tax imposed on the shareholders of the corporation, such that the income tax base is not completely eroded through the use of corporations to earn income. [19] That is, while carrying on business through a corporation will result in a deferral of a portion of the personal income tax that would be payable absent the existence of the corporation, an integrated corporate income tax ensures that some portion of the economic benefit to the shareholders is taxed currently and that the amount of the deferral is palatable.

In a theoretically perfect world, integration would be achieved in the manner identified by the Carter Commission. There would be no corporate income tax, and the individual shareholders of the corporation would instead be taxed on any dividends received in the year, the appreciation of the shares during the year and any gain or loss realized on a disposition of the shares during the year. However, this approach was considered impractical for two reasons. First, the valuation of shares on an annual basis would be difficult, particularly if shares were not publicly traded. Second, having regard for the substantial aggregate interests in Canadian corporations owned by non-residents, the absence of a corporate income tax in favour of a tax on shareholders who Canada might not be able to tax could lead to a substantial revenue loss. [20]

There are, of course, alternatives that would allow for the elimination of the corporate income tax and the consequential elimination of surplus stripping in a manner that is different than that proposed by the Carter Commission. For example, as noted by the Carter Commission, one option could be to tax corporations in the same manner as partnerships, with income calculated at the corporate level and then allocated to the shareholders. A not dissimilar option would be to tax corporations on an imputation basis similar to that used for the foreign accrual property income ("**FAPI**") of a controlled foreign affiliate in section 91 . Under such an imputation system, the taxable income or loss of a corporation would be allocated to the shareholders of the corporation, resulting in an increase in the ACB of the shares, with distributions received tax-free to the extent of the shareholder's ACB.

With either of these alternatives, there would be the sort of administrative difficulties noted by the Carter Commission, particularly for widely-held corporations where shareholders will routinely dispose of and acquire shares at various points during the taxation year. Further, neither option would address the concern with respect to the taxation of economic benefits accruing to non-resident shareholders in the same manner as a corporate income tax. However, both of these concerns may have been somewhat overstated.

The administrative difficulties associated with imputation or partnership taxation for widely-held corporations would be significant, but, with the digitization of corporate records, are no longer impossible (as was demonstrated by the proliferation of income trusts). As an alternative, a government with a great deal of faith in the literature relating to the inefficiency of corporate income taxes could give serious consideration to eliminating the corporate income tax for public corporations and not replacing it with any form of imputation, thereby taxing only the shareholders on dividends received from the corporation and capital gains realized on the disposition of shares at higher rates (or, alternatively, leaving dividend and capital gains rates unchanged and increasing the rates of wage and consumption taxes). [21] This would create a significant and potentially inequitable difference between public and private corporations, but this might be justifiable as a strong incentive for corporate growth.

In the private corporation context, this regime is certainly possible to administer; the difficultly with the FAPI regime is not imputation *per se*, but the challenge of capturing the various means by which income may be re-located to a foreign jurisdiction and suppressed. For a domestic private corporation, the adoption of an imputation system would not be any more complicated than the current regime for taxing corporations or partnerships, as the same income and loss determinations currently required for corporations would need to be made, and the imputation of income and losses to shareholders should not be materially different than an allocation of income and losses by a partnership.

A difficulty that would arise is the taxation of income imputed to a non-resident shareholder of a private corporation, which, as noted by the Carter Commission could escape Canadian taxation entirely. Even if the result were that non-residents shareholders could escape Canadian taxation entirely, it is not obvious how much revenue would be lost. The marginal effective tax rate on the income of private corporations controlled by non-residents is likely significantly less than 25% due to base erosion using interest-bearing debt and payments for the use of intangibles, as well as other forms of profit shifting. Moreover, the effective elimination of the corporate income tax for non-resident shareholders might also stimulate investment in Canada, resulting in additional revenue in the form of natural resource rents, personal income tax on wages and consumption taxes.

If it were necessary to impose tax on income imputed to non-resident shareholders, this could be done by imposing a withholding tax on the income imputed to the non-resident shareholder at a rate that approximates the current corporate income tax rate (subject to reductions under our bilateral tax treaties), with the elimination of withholding tax on distributions in order to mirror the treatment of Canadian resident shareholders. Non-resident shareholders would still be subject to Canadian income tax on the gains realized on the disposition of shares that are "taxable Canadian property" within the meaning in subsection 248(1) .

Harmonizing Dividend and Capital Gains Rates

One means of curtailing surplus stripping would be to significantly reduce the available benefit by taxing capital gains and dividends at an identical rate. The Carter Commission proposed a form of harmonization, in which corporate income, dividend income and capital gains would all be subject to tax at a 50% rate, with shareholders receiving dividend tax credits equal to the corporate income tax paid. Had this proposal been adopted, there would have been an incentive to distribute previously-taxed income as a dividend, and the shareholders would have been indifferent as between receiving a dividend or realizing a capital gain attributable to previously untaxed income. [22]

The proof of concept for harmonization can be seen in Alberta, where eligible dividends and capital gains are taxed at rates that are materially similar (19.29% vs. 19.50%) and the transaction costs of planning to receive an eligible dividend instead of receiving a capital gain, or *vice versa*, will likely exceed the tax benefit. In these circumstances, the only reason why a taxpayer might consider surplus stripping is to attempt to recover share ACB in excess of PUC, which should not be objectionable if the share ACB was not created using V-Day value or capital gains deductions of the taxpayer or non-arm's length individuals. In contrast, the difference between the rate of tax on non-eligible dividends and capital gains (29.36% vs. 19.50% in Alberta) is significant, and creates an incentive for surplus stripping.

As noted above, surplus stripping is typically not a concern with respect to the retained profits of a CCPC that are attributable to its investment income, as the refundable tax regime creates a strong incentive to pay dividends in order to recover RDTOH even if those dividends are taxed at the non-eligible rate. Where "surplus stripping" is a concern is in situations where the CCPC has undistributed business profits that were taxed at the preferential small business rate, or in situations where the CCPC is in a position to make distributions that are attributable to untaxed asset appreciation (such that there will not be a corresponding balance in the CCPC's "general rate income pool" ("**GRIP**")).

The logical conclusion is that, were it possible to eliminate situations in which distributions are taxed at non-eligible dividend rates, and were it possible to tax capital gains at the same rate as eligible dividends, then surplus stripping might be far less prevalent. The former issue would have to be addressed by taxing all corporate business income at a uniform rate, such that eligible dividends need not be attributable to GRIP, and such that only dividends attributable to the investment income of a CCPC would be taxed at non-eligible rates. In essence, this would require the Act to be amended to treat all CCPCs as if they had made a subsection 89(11) election, and, of course, to eliminate the small business deduction.

Although such a change to the scheme of taxing CCPCs would likely be initially unpopular, there appear to be solid policy reasons for questioning whether the small business deduction is a worthwhile tax expenditure. It may be reasonable to conclude that reduced statutory rates for small corporations are less effective in enhancing productivity than reductions in the general corporate tax rate, particularly since small corporations are less sensitive to corporate taxes and non-tax factors may have a larger impact on entrepreneurship. [23] Indeed, as noted by Mintz and Chen, the small business deduction may be antithetical to growth, as it rewards inefficient structures put in place to "double up" the small business deduction, distorts decisions relating to organizational form and encourages firms to stop growing their asset bases in order to restrict "taxable capital" and avoid the corresponding increased tax rate. [24]

According to the Department of Finance, the cost to the fisc of the small business deduction is approximately $3,000,000,000 per year, [25] and this estimate does not include provincial tax expenditures, which may exceed the federal tax expenditure in the aggregate. [26] If it does not achieve its desired objectives of encouraging entrepreneurship and growth, while further draining the fisc by creating incentives for "surplus stripping", it is reasonable to question whether the small business deduction is worth the cost. Preferred alternatives might include further base broadening and rate reduction, a capital gains incentive for shareholders on the corporation becoming a public corporation, or limited expensing of capital expenditures. [27]

The difference in the effective tax rates on capital gains and eligible dividends is largely a function of provincial tax policy. Under the Act, the maximum effective rate on a capital gain is 14.5%, and the maximum effective rate of tax on eligible dividends is 19.29%, so there is a potentially meaningful spread. In Alberta, effective harmonization is possible because both corporations (other than CCPCs with small business income) and individuals are taxed at a flat 10% rate, [28] so, in order to preserve integration, the Alberta dividend tax credit on eligible dividends is equal to the personal income tax payable on the grossed-up dividend. [29]

In essence, for harmonization to be possible, it is necessary for the non-Alberta provinces to set their rates of personal income tax and corporate income tax and the amount of the eligible dividend tax credit in such a manner that the integrated combined federal-provincial rates of tax on capital gains and eligible dividends are approximately equal. The other provinces need not adopt income tax rates as low as Alberta's or a flat rate personal income tax in order to achieve this objective, but would have to decide on their tax rates with this objective in mind. That being said, the difficulty in multi-province coordination makes it likely that, even with a single federal rate of tax on corporate business income, some meaningful gap will persist in some provinces between the effective rate of tax on capital gains and the effective rate of tax on eligible dividends.

Eliminating the Capital Gains Deduction and V-Day Increment

For private corporations and their shareholders, the potential use of the subsection 110.6(2.1) capital gains deduction for qualified small business corporation shares ("**QSBC Shares**") to engage in surplus stripping is often a temping opportunity, and it is unsurprising that the use of the capital gains deduction is a feature in many surplus stripping arrangements (including the "employee buyco" arrangement described below). The availability of V-Day increment also presents an opportunity for surplus stripping (as in the *Descarries* [30] case discussed below).

While subsection 84.1(1) would ordinarily apply to prevent surplus stripping in the form of a straightforward exchange of a shareholder's shares for property of the corporation, it does not apply to prevent surplus stripping using "hard" ACB (i.e., ACB resulting from an arm's length share purchase, or a non-arms length transaction in which the capital gain on the share transfer was not sheltered by a capital gains deduction or V-Day increment).

If a shareholder realizes a capital gain on his or her shares in any manner that does not involve the claiming of a capital gains deduction or V-Day increment, the shareholder will have hard ACB in those shares to the extent of the gain, and subsection 84.1(1) would not apply if the shares were exchanged for a note or high-PUC shares of another non-arm's length corporation. This significant gap in the legislative scheme supports the contention that there is not a general scheme of the Act relating to surplus stripping, as Parliament must be aware of the potential for rate arbitrage in circumstances where hard ACB is created.

Subsection 84.1(1) does apply in a more robust fashion to shares with "soft" ACB described in subsection 84.1(2), which was either created by owing property on V-Day or through the use of the capital gains deduction. It is this "soft" ACB that presents the most attractive tax planning opportunities, as utilizing V-Day increment or the capital gains deduction while avoiding subsection 84.1(1) permits the tax-free extraction of corporate surplus. Unsurprisingly, the need to police the direct or indirect use of "soft" ACB adds complexity to section 84.1. [31]

Again, the potential use of the capital gains deduction for surplus stripping and the complexity created in order to restrict its use raises the question of whether it might be better to eliminate the capital gains deduction. The capital gains deduction costs the federal fisc approximately $990,000,000 each year, [32] with additional costs for the provinces. [33] If a significant portion of this tax expenditure is attributable to surplus stripping instead of arm's length sales of small businesses or farming and fishing businesses, then the cost may be difficult to justify, to the extent that the capital gains deduction can be justified at all.

The stated purpose of the capital gains deduction is to encourage risk-taking activity and encourage entrepreneurial activity amongst individual Canadians, as well as to assist corporations in raising capital. [34] However, scepticism about the targeting of the capital gains deduction has existed from the outset, [35] and, like the small business deduction, it is not clear that the capital gains deduction actually increases entrepreneurship. Indeed, like the small business deduction, it is arguable that the capital gains deduction encourages inefficient decisions with respect to firm size or capitalization. [36] As a practical matter, the limiting of the capital gains deduction to shares of corporations that meet certain asset tests may also incentivize non-neutral and inefficient decisions relating to corporate investment.

Further, it is reasonable to question whether there is a distributional problem with the capital gains deduction. While the former $100,000 lifetime capital gains exemption may not have been regressive, this may not be true with respect to the capital gains deduction for QSBC shares. [37] Even if the capital gains deduction were not regressive and did in fact assist farmers and small business owners in meeting retirement savings shortfalls, there is an argument that it is unfair to extend this assistance to some but not all disadvantaged taxpayers. [38] However, empirical data suggests that taxpayers claiming the capital gains deduction on QSBC shares contribute more to retirement savings plans than the average taxpayer and 75% of all QSBC capital gains deductions were claimed by taxpayers having an average income of $191,709 (in 2014 dollars), or five times the average taxable income at the time of the sample.[39] While there is some evidence that the farm capital gains deduction is achieving its policy objective, it is also worth noting that 15% of the farm claimants in the sample were not farmers.[40]

In reality, the targeting of the capital gains deduction may be even worse than the empirical data suggests. Given the proliferation of plans to multiply the capital gains deduction between small business owners and their non-working spouses, children and grandchildren, it is entirely possible that the mean income of the actual business owners is higher than the data suggests.[41] Certainly, even if the empirical data is to be taken at face value, it is difficult to justify an increase in the amount of the QSBC capital gains deduction from $500,000 (in 1995) to $800,000, as the increased tax expenditure is most likely to benefit high income taxpayers.

With respect to V-Day increment, it is not clear how much revenue is currently being saved by the inclusion of V-Day increment ACB as "soft" ACB in subsection 84.1(2). Lock-in effects notwithstanding, V-Day was over 40 years ago, and it seems unlikely that there would be a significant amount of V-Day assets remaining in the hands of the hands of the V-Day owners or any non-arm's length persons. While the *Descarries* demonstrates that there is undoubtedly some V-Day increment ACB remaining in circulation that could be used for "surplus stripping", the amount of such ACB is likely not sufficient to justify the continued existence of the "soft" ACB concept in the event that the capital gains deduction were repealed.

Having regard for the foregoing, it may be reasonable to consider the elimination of the capital gains deduction as a means of restricting surplus stripping to pure rate arbitrage and reducing the potential for complete elimination of tax payable on the extraction of funds from corporate solution. Concurrent with the elimination of the capital gains deduction, section 84.1 could be amended to eliminate references to both V-Day increment and the capital gains deduction, thereby simplifying the Act. As an added benefit, this proposal could ameliorate the distributional issues relating to the capital gains deduction.

Legislation and History

Historical Legislation

The history of Parliament's attempts to address corporate distributions and surplus stripping prior to 1966 is summarized in detail in Chapter 5 and Appendix D of the Carter Commission's report, and an excellent summary of the post-1966 legislation is contained in the Couzin and Stikeman manuscript.[42] For the purposes of this discussion, we will only consider the legislation implemented following Parliament's decision to tax dividends and exempt inter-corporate dividends, and only the provisions that are intended to be applicable to surplus stripping.

The first such provision, section 14 of the *Income War Tax Act*, was enacted in 1926 and stated that where an individual sold shares to a corporation controlled or promoted by the individual or acting as his agent, and that corporation received a dividend on the shares which was used to fund the purchase price, that dividend was taxable in the hands of the transferor. In effect, the section 14 was a precursor to subsection 84.1(1), drafted at a simpler time when capital gains were not taxed. This was obviously not a particularly robust anti-avoidance rule, and, unsurprisingly, did not put a stop to surplus stripping.

Next, Parliament enacted section 32A of the *Income War Tax Act* in 1938, which gave the Treasury Board the power to dictate the tax consequences of certain transactions if the main purpose of the transaction was tax avoidance, including surplus stripping. As noted by the Carter Commission and by

Stikeman and Couzin, this provision was never used to prevent surplus stripping, and was not used at all after 1949.

Section 14 of the *Income War Tax Act* and the parts of section 32A of the *Income War Tax Act* addressing surplus stripping were repealed upon the enactment of the 1948 *Income Tax Act*. Replacing these anti-avoidance rules was the "designated surplus" concept. Where the shares of a corporation were acquired by another corporation, the undistributed income on hand (i.e. the retained earnings) of the corporation became the "designated surplus" of the corporation. When a dividend was paid from "designated surplus" on shares owned by another corporation, that other corporation would not be entitled to a deduction for inter-corporate dividends, resulting in double taxation of corporate income.

Taxpayers quickly identified that the "designated surplus" of a corporation could be eliminated by paying dividends to non-residents or tax-exempt persons, so section 105B of the *Income Tax Act* was enacted in 1955 to impose a tax on dividend paying corporations equal to 15% or 20% of the "designated surplus" dividends paid to non-residents, tax-exempt persons, etc. Sections 85I and 105C of the *Income Tax Act* were enacted in 1958 and 1959, respectively, to impose a tax on an amalgamated corporation if the amalgamation caused the disappearance of "designated surplus". However, the Carter Commission characterized these supporting rules as being relatively ineffective and deficient.

The final pre-reform measure was the enactment of section 138A in 1963, which provided that, where a taxpayer had disposed of shares of a corporation and an amount was received by the taxpayer for the purpose of substantially reducing the assets of the corporation in such a manner that the tax on the distribution of those assets would be avoided, the amount would be included in the income of the taxpayer as a taxable dividend. This provision remained in the Act following the 1971 tax reform as subsection 247(1), but was not relied on subsequent to 1971.[43] Subsection 247(1) was repealed in 1988 upon the enactment of the GAAR.

The concept of "designated surplus" survived the 1971 tax reform in former Part VII and former subsections 18(4), 112(5) and 248(1), and was made complex to the point of being incomprehensible. The 1971 tax reform also introduced the original section 84.1 with its "debt limit" concept that caused a deemed dividend to arise on the payment of certain indebtedness, and the "paid-up capital deficiency" in former 87(2)(s.1) that prevented the increase of PUC on amalgamations. All of these provisions were repealed in 1977, leaving behind what are effectively the anti-surplus stripping provisions that remain today.

Subsection 84(2)

As has been noted, subsection 84(2) is not an anti-avoidance or an anti-surplus stripping provision *per se*,[44] but it is an important tool in the Minister's arsenal for attacking the more blatant forms of appropriating corporate assets. Subsection 84(2) has returned to prominence as a result of some of the recent decisions described below, and the somewhat broader interpretation of subsection 84(2) in those cases has led to concerns relating to relatively standard planning techniques.

Subsection 84(2) originally existed as subsection 19(1) of the *Income War Tax Act*, and, at the time of the transactions in *Merritt v. M.N.R.*,[45] read as follows:

> (1) On the winding up, discontinuance or reorganization of the business of any incorporated company, the distribution in any form of the property of the company shall be deemed to be the payment of a dividend to the extent that the company has on hand undistributed income.

This was a relatively simple provision. On the winding-up, discontinuance or reorganization of the business, any distribution of property was deemed to be a dividend to the extent of "undistributed income" (essentially retained earnings). There was no attempt on the part of Parliament to identify the persons to whom property could not be distributed, nor was there any attempt by Parliament to capture indirect distributions.

In the 1948 *Income Tax Act*, subsection 84(2) existed as subsection 81(1). By 1961, subsection 81(1) had taken a form that would look familiar to most contemporary tax practitioners:

> 81. (1) Where funds or property of a corporation have, at a time when the corporation had undistributed income on hand, been distributed or otherwise appropriated in any manner whatsoever to or for the benefit of one or more of its shareholders on the winding-up, discontinuance or reorganization of its business, a dividend shall be deemed to have been received at that time by each shareholder equal to the lesser of
> (a) the amount or value of the funds or property so distributed or appropriated to him, or
> (b) his portion of the undistributed income then on hand.

Most of the core elements of subsection 84(2) were found in subsection 81(1) of the 1948 *Income Tax Act*. The critical differences were that subsection 84(2) only applied to the extent of "undistributed income" and only to the extent that any particular shareholder received property that was distributed or appropriated to the shareholder.

In the initial post-tax reform period, the application of subsection 84(2) depended in part on the "paid-up capital limit" of the corporation. After the repeal of *this* concept in 1977, subsection 84(2) took on its current form, providing as follows:

> (2) Distribution on winding-up, etc. - Where funds or property of a corporation resident in Canada have ... been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares in its capital stock, on the winding-up, discontinuance or reorganization of its business, the corporation shall be deemed to have paid at that time a dividend on the shares of that class equal to the amount, if any, by which,
> (a) the amount or value of the funds or property distributed or appropriated, as the case may be,
> exceeds
> (b) the amount, if any, by which the paid-up capital in respect of the shares of that class is reduced on the distribution or appropriation, as the case may be,
> and a dividend shall be deemed to have been received at that time by each person who held any of the issued shares at that time equal to that proportion of the amount of the excess that the number of the shares of that class held by the person immediately before that time is of the number of the issued shares of that class outstanding immediately before that time.

As identified by the Federal Court of Appeal, subsection 84(2) has four conditions of application that must be met in order for a deemed dividend to arise:

1. The corporation in question must be resident in Canada;
2. The corporation must be winding-up, discontinuing or reorganizing its business;
3. A distribution or appropriation of the corporation's funds or property in any manner whatever; and
4. The distribution or appropriation is to or for the benefit of its shareholders. [46]

Where these conditions of application are satisfied, the result is that the shareholders of the class of shares of the corporation in respect of which the distribution or appropriation is made are deemed to have received a dividend equal to their proportionate share of the amount, if any, by which the distribution or appropriation exceeds the PUC of the shares of that class.

The most important recent dispute relating to the interpretation of subsection 84(2) concerns the "in any manner whatever" language in the preamble, and this point is discussed below. However, one point of particular importance that is less frequently commented on is the requirement that there be a "*winding-up, discontinuance or reorganization* of [the] *business*" of the corporation. The precise meaning given to these terms, particularly in the context of the "pipeline" plans described below, can be of critical importance in applying subsection 84(2).

First, a plain reading of subsection 84(2) makes it clear that the corporation must be carrying on a "business" in order for subsection 84(2) to apply; if there is no "business", than subsection 84(2) should be inapplicable. While the income of a corporation is *prima facie* income from a "business" of the corporation, this presumption is rebuttable.[47] Whether the presumption will be rebutted depends on the corporation's conduct in light of all of the circumstances, including the number of transactions, the volume of transactions, the frequency of transactions, the turnover of investments and the nature of investments.[48] If the corporation holds a limited number of passive investments and does not actively trade, it is possible that presumption of business income has been rebutted.

While it is clearly possible to carry on a business of earning from property, this does not necessarily mean that every corporation that earns income from property is carrying on a business of earning income from property. In this respect, the CRA's published administrative position of not attempting to differentiate between corporations that may or may not be engaged in a "business" is indefensible.[49] Regardless of the *prima facie* characterization of corporate activities and income and the broad meaning of the term "business" in subsection 248(1), there will be circumstances where the *Canadian Marconi* presumption will be rebutted and the corporation will not be carrying on a business.

However, the CRA does raise a valid point with respect to investment assets that were following the discontinuance of a business previously carried on by the corporation. There is authority for the proposition that the term "on the winding-up..." of the business may be interpreted as meaning "as a result of" or "consequential to" the winding-up, etc., of the business.[50] That said, concepts like "as a result of" or "consequential to" should be subject to the Supreme Court's direction that connections between things should not be extremely remote.[51] If the corporation did carry on a business at some point in the recent past, and the passive investments were acquired using money obtained on the liquidation of the business or from the income of the business, then there is a reasonable argument that subsection 84(2) could apply even if there is no business currently carried on by the corporation.[52]

The remaining words in the second condition of application of subsection 84(2) are less contentious. There is not an obvious distinction between the "winding-up" or the "discontinuance" of the business of a corporation; both are a process and include every transaction undertaken as part of the process,[53] and would involve the permanent cessation of the particular business and the liquidation of the assets used in the course of that business.[54] A "reorganization" is an event wherein a specific undertaking that was carried on continues to be carried on in an altered form by substantially the same persons who previously carried it on.[55] These are relatively broad terms, and most transactions that could attract the application of subsection 84(2) are likely to be a "winding-up, discontinuance or reorganization".

Section 84.1

To the extent that the Act contains a rule that addresses "surplus stripping" in the domestic context, section 84.1 is that rule. The history and policy rationale for section 84.1 has been addressed above, and need not be restated. Speaking generally, section 84.1 is intended to prevent taxpayers from directly exchanging low-PUC or low-ACB shares for corporate assets without paying a dividend, while also preventing exchanges of high-ACB shares for corporate assets in circumstances where the ACB arose from a non-taxable transaction or event.

At its core, subsection 84.1(1) is relatively straightforward, and will apply where the following conditions of application are met: [56]

1. A taxpayer disposes of shares;
2. The taxpayer is a resident of Canada that is not a corporation;
3. The shares disposed of were capital property of the taxpayer;
4. The shares are shares in the capital stock of a corporation resident in Canada (the "subject corporation");
5. The shares are disposed of to another corporation (the purchaser corporation");
6. The taxpayer does not deal at arm's length with the purchaser corporation; and
7. Immediately after the disposition, the subject corporation is "connected" with the purchaser corporation (as defined in subsection 186(4)). [57]

Where these conditions of application are satisfied, two things will happen. First, paragraph 84.1(1)(a) provides that the PUC of any shares of the purchaser corporation will be reduced by the amount that the PUC of those shares exceeds the PUC of the shares of the subject corporation shares disposed of. Second, to the extent that any non-share consideration is received, paragraph 84.1(1)(b) the taxpayer is deemed to receive, and the purchaser corporation is deemed to pay, a dividend equal to the amount, if any, by which the PUC of the purchaser corporation shares issued plus the FMV of any boot received exceeds the total of the PUC of the subject corporation shares plus the amount of the paragraph 84.1(1)(a) PUC reduction.

Applying subsection 84.1(1) to an exchange of shares for boot of a non-arm's length corporation is not particularly difficult; the complexity is in the rules that modify the meaning of the words that appear in subsection 84.1(1). A non-exhaustive list of these rules would include the following:

1. The ACB of a share acquired prior to 1972 is equal to the actual cost of the share plus any dividend received under former subsection 83(1); [58]

2. The ACB of a share acquired after 1971 from a non-arm's length person, and any share substituted therefor, is reduced by amounts that are commonly referred to as "soft ACB", including:

   (a) The amount, if any, by which the V-Day value of the share exceeds its actual cost plus any dividends paid on the share under former subsection 83(1) ; and
   (b) The amount of any previous capital gain realized in relation to the share that was sheltered by the section 110.6 capital gains deduction; [59]

3. Persons are deemed not to deal at arm's length in two circumstances:

   (a) A taxpayer does not deal at arm's length with a purchaser corporation if the taxpayer was a member of a group of fewer than 6 persons that controlled the subject corporation and is a member of a group of fewer than 6 persons that controlled the purchaser corporation, each member of the latter group being a member of the former group; [60] and
   (b) A trust does not deal at arm's length with a beneficiary of the trust or a person related to a beneficiary; [61]

4. A "group" is a mathematical aggregation of any two or more persons who own shares of a corporation, without regard for whether there is any common connection between the members; [62]

5. In determining if the taxpayer is a member of a "group" that controls a corporation, the taxpayer is deemed to own deemed to own shares of owned by:

   (a) The taxpayer's spouse or minor child;
   (b) A corporation controlled by the taxpayer, the taxpayer's spouse or the taxpayer's minor child; and
   (c) A trust of which the taxpayer, the taxpayer's spouse or minor child or a corporation controlled by the taxpayer, the taxpayer's spouse or the taxpayer's minor child is a beneficiary; [63] and
   (d) A corporation that is controlled by one or more members of a group is controlled by that group, and a corporation can be controlled by a group even if it is controlled by another group of persons. [64]

The application of subsection 84.1(1) turns on six bright line tests and the more nebulous "arm's length" standard in subsection 251(1), so it is not surprising that much of the section 84.1 jurisprudence relates to the determination of whether parties deal at arm's length. [65] Occasionally, this is a matter of interpreting the modifying rules in subsections 84.1(2.01) and (2.2), [66] but more often relates to the factual arm's length standard in subsection 251(1). [67]

A complete discussion of the meaning of the term "arm's length" in subsection 251(1) is beyond the scope of this paper, and, in the case of related persons and trust beneficiaries addressed by paragraphs 251(1)(a) and (b), respectively, the determination is relatively straightforward. In the case of the paragraph 251(1)(c) factual arm's length determination, the question of whether or not two persons deal at arm's length should be resolved by reference to the following three-factor test:

1. *Whether a common mind directs bargaining for both parties* - this factor requires a determination of whether the transaction is entered into freely by both parties after considering their own interests, and have the ability to negotiate the terms of the transaction (even if they do not do so);

2. *Whether the parties are acting in concert without separate interests* - whether the parties have potentially divergent economic interests, and have some interest, whether economic or otherwise in completing the transaction (even if there is no immediate monetary benefit); and

3. *Whether one party exercises de facto control over the other* - whether one party exercises a sufficiently great influence over the other party that the other party would enter into a transaction that is not mutually beneficial at the first party's behest. [68]

The weight that should be given to each of these factors will vary from case to case, and it is possible that other factors could be considered. Ultimately, the determination that must be made is whether the terms of the transactions completed reflect ordinary commercial dealings between parties acting in their own interests. [69]

Section 212.1

The final provision that may be briefly commented on is section 212.1, which is the equivalent of section 84.1 for non-resident shareholders. Section 212.1 operates in a manner that is substantially similar to section 84.1, but its scope is considerably broader, applying to non-resident corporations and partnerships as well as non-resident individuals, and based only on PUC and not on ACB (gains that could be used to create such ACB not being taxed in Canada unless such shares are "taxable Canadian property" as defined in subsection 248(1)).

A plain reading of subsection 212.1(1) reveals several conditions precedent, which, similar subsection 84.1(1), are primarily bright-line tests:

1. A person or partnership disposes of shares;
2. The person or partnership is a non-resident or "designated partnership";
3. The shares disposed of are shares in the capital stock of a corporation resident in Canada (the "subject corporation");
4. The purchaser of the shares is a corporation resident in Canada (the "purchaser corporation");
5. The purchaser corporation and the non-resident do not deal at arm's length with one another; and
6. The purchaser corporation and the subject corporation are "connected" (within the meaning in subsection 186(4) after the transfer.

Aside from the requirement that the person disposing of shares be a non-resident, the immediately apparent distinctions between subsection 212.1(1) and subsection 84.1(1) are that the shares disposed of need not be capital property, and that the vendor need not be an individual or a trust. Not only can the vendor be a non-resident corporation, it may also be a "designated partnership" with a non-resident majority-interest partner or majority-interest group of partners. [70]

While the tax consequences of the application of subsection 212.1(1) and subsection 84.1(1) are similar, there are differences in the ordering. Pursuant to paragraph 212.1(1)(a) , any property received from the corporation in excess of the PUC of the shares disposed of will result in a deemed dividend, regardless of whether or not shares in respect of which a PUC "grind" could be effected have been received. This dividend is subject to withholding tax under subsection 212(2). [71] If shares have been received, then paragraph 212.1(1)(b) will reduce the PUC of the shares by the amount, if any, that the PUC of the subject shares exceeds the amount of the deemed dividend received.

An important difference between subsection 212.1(1) and subsection 84.1(1) is that, in the cross-border context, only PUC can shelter a payment from deemed dividend treatment. ACB in excess of PUC cannot be extracted via a cross-border non-arm's length pipeline transaction, because subsection 212.1(1) provides that boot received by the vendor in excess of the PUC of the shares is subject to deemed dividend treatment.

The modifying rules in subsection 212.1(3) are substantially similar to the modifying rules in subsections 84.1(2) and (2.2) , but include special rules relating to partnerships. In particular, in applying the "group of fewer than 6" test, a partnership will be looked though and its shares attributed to the taxpayer if the majority-interest partner of the partnership is the taxpayer, the taxpayer's spouse or minor child, a trust of which the taxpayer, the taxpayer's spouse or minor child or a corporation controlled by any of these individuals is a beneficiary, or a corporation that is controlled by any such individual. [72] In addition, a partnership is a person for the purposes of applying the modifying rules. [73]

Like subsection 84.1(1) , there are no cases that consider the application of the technical requirements of subsection 212.1(1) , which are relatively straightforward. The identification of arm's length relationships has been an issue, [74] as has the existence of the transaction in respect of which the technical requirements of subsection 212.1(1) would have been met. [75]

Surplus Stripping Jurisprudence

There is a large body of jurisprudence covering technical section 84, 84.1 and 212.1 issues, as well as GAAR challenges of various types of surplus stripping arrangements.[76] On the technical front, the principles that govern the application of the statutory provisions have become fairly well settled, but unfortunately do not always provide strong guidance for navigating the technical provisions of the Act. Some clear principles have also developed in the GAAR jurisprudence that generally provide comfort for surplus stripping strategies that are not solely focused on monetizing capital gains deductions.

Types of Surplus Stripping Transactions

There are three broad categories of tax plans that have been addressed in the surplus stripping jurisprudence:

1. Share sales to arm's length accommodation parties.
2. "Pipeline" transactions involving a sale of shares to a non-arm's length corporation.
3. Hybrid asset/share sale transactions, in which a shareholder arranges to sell some shares as part of what is primarily a purchase and sale of corporate assets. The share sale is accommodated by the purchaser to allow the shareholder to receive a portion of the sale proceeds personally, and the capital gain on the share sale is typically sheltered by the capital gains deduction in section 110.6 .

The type of plan under consideration by the Court in each case appears often seems to impact the technical analysis, and certainly impacts the GAAR analysis. The following is a summary of general principles that can be observed from the treatment that each type of plan has received in the Courts so far.

Share Sales to Arm's Length Accommodation Parties

The majority of the surplus stripping cases to date have involved share sales to arm's length accommodation parties.[77] Each case has its own particular twists and turns, but the key features that impact the technical analysis and the GAAR analysis are generally the same, and include the following:

1. The corporation that will be stripped of its surplus typically has assets consisting mostly of cash or marketable securities, and has ceased carrying on business or will cease carrying on business at the conclusion of the transactions.
2. The object is generally, but not always, to get the corporate assets into the shareholders' personal hands. In some cases (*Smythe, McMullen*), the assets remain in corporate solution but the shareholder's investment is converted from a low-PUC low-ACB share to a tax-paid shareholder loan.
3. The capital gain at the shareholder level is created by selling shares to an arm's length corporation (the accommodator). The purchase price for the shares typically is financed using a daylight loan.
4. The corporation that is stripped is usually dissolved or amalgamated with the accommodator without significant tax consequences, and most of the corporate assets are used to repay the daylight loan that was used to fund the share purchase. The accommodator retains some funds or corporate assets as an economic incentive for participating in the transactions.
5. If the stripped corporation is not dissolved, it usually is left with no assets at the conclusion of the

transactions. [78]

6. Taxation of the capital gain realized on the share sale is avoided, either because capital gains are not taxable (in the older cases) or because the shareholder is in a position to claim the capital gains deduction under section 110.6 . The exception was *Tremblay*, [79] in which the transfer of shares to the accommodator was done on a rollover basis. [80]

The accommodation cases have generated considerable analysis of subsection 84(2) , sections 84.1 and 212.1 , and the GAAR, and a fairly consistent set of principles has emerged.

Subsection 84(2) in Accommodation Transactions

Subsection 84(2) has proved difficult to navigate in share sales to accommodation parties. Of the seven reported cases involving the potential application of subsection 84(2) to accommodation transactions, [81] only three did not result in the application of subsection 84(2). Two of those three cases have subsection 84(2) analysis that is questionable (*McMullen*) [82] or inconsistent with the remaining cases (*McNichol*). [83] The third case in which subsection 84(2) did not apply (*Tremblay*) [84] is a factual outlier that may be hard to replicate in practice.

From a tax planning perspective, it must be acknowledged that, at a minimum, it is very difficult to avoid subsection 84(2) on a share sale to an accommodation party that is done for the purpose of putting corporate cash in the hands of the shareholders. The jurisprudence has consistently identified two fundamental technical problems with the accommodation transactions.

First, the language of subsection 84(2) which provides that deemed dividend treatment results where corporate assets are "appropriated in any manner whatever" is sufficiently broad to allow the share sale to the accommodator to be treated as a step in the winding-up process and not as a separate transaction. The shareholder cannot defend against a subsection 84(2) assessment by arguing that he received share sale proceeds in his capacity as a creditor of the accommodation party, and not in his capacity as a shareholder of the corporation being stripped.

The following passage from the Tax Court of Canada's judgment in *RMM Enterprises* illustrates the reasoning on this issue that generally has been applied to accommodation transactions:

> What of the fact that there was a sale of shares? Of course there was a sale. It was not a sham. "Sale of shares" is a precise description of the legal relationship. Nor do I suggest that the doctrine of "substance over form" should dictate that I ignore the sale in favour of some other legal relationship. That is not what the doctrine is all about. Rather it is that the essential nature of a transaction cannot be altered for income tax purposes by calling it by a different name. It is the true legal relationship, not the nomenclature that governs. The Minister, conversely, may not say to the taxpayer "You used one legal structure but you achieved the same economic result as that which you would have had if you used a different one. Therefore I shall ignore the structure you used and treat you as if you had used the other one".
>
> <u>One cannot deny or ignore the sale. Rather, one must put it in its proper perspective in the transaction as a whole. The sale of EL's shares and the winding-up or discontinuance of its business are not mutually exclusive. Rather they complement one another. The sale was merely an aspect of the transaction described in subsection 84(2) that gives rise to the deemed dividend.</u>
>
> [Emphasis added]

The Tax Court of Canada's judgment in *McNichol* went the opposite way on this issue, with the Court finding that the share sale to the accommodator "was the end of the matter" as far as the share vendors were concerned, and could not be linked to the subsequent events by which the corporation's cash was accessed by the accommodator and used to repay the daylight loan that funded the share purchase. [85]

The *McNichol* approach briefly had some life breathed into it in the Tax Court of Canada's decision in *MacDonald v R.,* [86] when the Tax Court relied on *McNichol* to find that subsection 84(2) did not apply to a pipeline transaction. [87] The Federal Court of Appeal reversed the Tax Court's decision and expressly endorsed the approach that was taken in *RMM Enterprises*. [88] This issue likely now can be taken as settled, if that was not already the case given that *McNichol* was the only outlier.

The second technical problem that has consistently arisen in the jurisprudence is that the Courts have viewed cash as being fungible when applying subsection 84(2). Strict tracing of the corporate assets into the hands of the original shareholders is not required, and the fact that the accommodator provides its own cash to fund the share purchase (usually through a daylight loan) does not avoid the conclusion that the original shareholder has received funds or property of the corporation that was stripped.

This approach has its history in the early surplus stripping cases from the Supreme Court of Canada (*Merritt* and *Smythe*), and has been applied in *David* and *RMM Enterprises*. The following passage from *RMM Enterprises* illustrates the reasoning used by the Courts treating the accommodator's funds as property of the corporation for the purposes of subsection 84(2):

> I do not think that the brief detour of the funds through RMM stamps them with a different character from that which they had as funds of EL distributed or appropriated to or for the benefit of EC. Nor do I think that the fact that the funds that were paid to EC by RMM were borrowed from the bank and then immediately repaid out of EL's money is a sufficient basis for ignoring the words "in any manner whatever". [89]

As with the first subsection 84(2) issue discussed above, the Tax Court of Canada decision in *McNichol* is an outlier. In that case, the Court distinguished the leading cases *Merritt* and *Smythe* for reasons that some commentators have questioned, [90] and applied a strict tracing method with the result that the cash used by the accommodator to buy the shares was not viewed as property of the corporation that was stripped. [91]

McNichol stands in direct opposition to most of the other accommodation cases on this point. In the authors' view, the weight of the jurisprudence on this issue favours the broader approach described in *RMM Enterprises* and we would be hesitant to rely on *McNichol* notwithstanding that this particular statement of law from *McNichol* has never been expressly overruled. [92]

There are two accommodation cases in which the taxpayers successfully argued that subsection 84(2) did not apply on the basis that the original shareholders did not receive funds or property of the corporation.

In *McMullen*, [93] the taxpayer was a 50% shareholder in a corporation (DEL) that operated a heating and air conditioning business from two locations in Belleville and Kingston, Ontario. The taxpayer and the other 50% shareholder dealt at arm's length, and wanted to sever their business relationship.

On their accountant's advice, they implemented a plan in which the taxpayer sold his shares of DEL for $150,000 to a new holding corporation owned by the other shareholder's wife. The share purchase was funded with a daylight loan and the taxpayer sheltered his capital gain using the capital gains deduction.

Following the share sale, the taxpayer loaned the $150,000 of share proceeds to a new corporation of which he and his wife were 50/50 shareholders, which in turn used those funds to purchase the assets of the Kingston branch from DEL. Following the asset sale DEL repaid the daylight loan that had been used to fund the share purchase.

The Tax Court of Canada in *McMullen* held that subsection 84(2) did not apply for two reasons. First, the Court did not view the sale of the Kingston branch as a "reorganization" of the business of DEL (subsection 84(2) applies only where corporate assets are appropriated on the winding-up, discontinuance or reorganization of a corporation's business). [94] There is relatively little jurisprudence explaining what constitutes a "reorganization" for the purposes of subsection 84(2), but the Court's decision on this point arguably is not consistent with comments made by the Supreme Court of Canada in *Merritt* and *Smythe* stating that the term "reorganization" should be given the meaning that would apply in a commercial context. [95]

The Tax Court's second reason for its refusal to apply subsection 84(2) was that, in its view, funds or property of DEL were not appropriated for the benefit of the taxpayer. This conclusion appears to have been influenced by the Court's observation that, at the time of the transactions, DEL had a deficit on its balance sheet and therefore did not have any retained earnings, unlike the situation in *Smythe* and *RMM Enterprises* in which the corporations had substantial retained earnings. [96]

This conclusion is difficult to reconcile with the language of subsection 84(2), which does not require that the corporation have a positive retained earnings balance. The fact that the Kingston branch assets remained in corporate solution might be a justification for concluding that assets of DEL were not appropriated to or for the benefit of a shareholder, but it is difficult to reconcile that theory with the result in *Smythe*, where the assets of the corporation that was stripped also remained in corporate solution while the shareholders were able to convert their shares of the original corporation into tax-paid debentures of a new corporation that purchased the assets of the original corporation.

Tremblay [97] is the other case in which subsection 84(2) did not apply on the basis that the original shareholders did not receive funds or property of the corporation. *Tremblay* was assessed by the CRA and was argued in the Tax Court and the Federal Court of Appeal as a surplus stripping case, but the plan in that case did not involve surplus stripping in the classic sense of converting dividend income to a capital gain.

In *Tremblay*, the taxpayers owned shares of a private holding corporation (8855) with a substantial accrued capital gain. The assets of 8855 consisted of convertible preferred shares and convertible debentures of Vidéotron, a public corporation. The Vidéotron shares and debentures had been acquired in a previous transaction where another Tremblay family holding corporation transferred shares of the Tremblay family's Quebec cable television company (Telesag) to Vidéotron on a rollover basis pursuant to subsection 85(1) .

The Tremblays were planning to emigrate from Canada and with the cooperation of Videotron undertook a series of transactions in which Vidéotron acquired 8855 from the Tremblays in exchange for subordinated voting common shares of Vidéotron. The share exchange transaction between the Tremblays and Vidéotron was on a tax-deferred basis pursuant to section 85.1 . Vidéotron caused 8855 to be wound-up after acquiring it from the Tremblays, and 8855's Vidéotron convertible preferred shares and convertible debentures were cancelled.

Vidéotron benefitted from the transaction because it was able to issue common stock to repurchase preferred shares and debentures that had very high dividend and interest rates, and the Tremblay family benefitted because they would not be subject to section 116 compliance on a future sale of the Vidéotron shares after ceasing to be resident in Canada. [98]

The Tax Court of Canada and the Federal Court of Appeal in *Tremblay* both concluded that subsection 84(2) did not apply because the Tremblays technically did not receive any funds or property of 8855.

In the Tax Court's view, the subordinated common shares that were issued to the Tremblays, being new shares issued by Vidéotron

from treasury, had not been property of 8855 and were not "legally identical" to the convertible preferred shares and convertible debentures of Vidéotron that were owned by 8855, notwithstanding that the subordinated common shares received by the Tremblays were the same class of shares that would have been issued to 8855 if it had exercised the conversion rights on its Vidéotron preferred shares and debentures. [99] The Federal Court of Appeal upheld the Tax Court of Canada's decision. The Crown relied heavily on *RMM Enterprises*, but the Federal Court of Appeal distinguished that case on the basis that the property in *RMM* did not "transform" - in *RMM*, the accommodator paid cash to acquire shares of a corporation with cash assets. The Court's view was that the Vidéotron common shares were not the same property that 8855 had owned and therefore subsection 84(2) did not apply. [100]

In the Federal Court of Appeal, one of the three Justices dissented, and would have applied subsection 84(2) based on *Smythe*, [101] and it is interesting to speculate whether the outcome may have been different if *Tremblay* had been a true surplus stripping case in which the shareholders' equity investment was cashed out. Subsection 84(2) likely was the wrong provision for attacking this transaction given that the share-for-share exchange was executed on a tax-deferred basis pursuant to section 85.1. The Crown argued at both levels of court that the taxpayers undertook the transactions to avoid realizing a capital gain on emigration pursuant to section 128.1, [102] and the courts noted that the Crown did not argue sham or GAAR. [103] The courts may have been reluctant to apply subsection 84(2) based on a perception that the Crown had not identified the true mischief (if any) and built its case on a more correct technical foundation.

In any event, it is unlikely that *Tremblay* presents a tax planning opportunity of general application for those interested in executing an accommodator transaction. In the domestic context, the main reason why a share sale to an arm's length accommodator would be considered is to cash out a shareholder's capital gains deduction or share ACB that is "soft" for the purposes of section 84.1. A rollover of shares from the share vendor to the accommodator (as in *Tremblay*) will not accomplish this, which will distinguish *Tremblay* and likely will make it difficult to rely on that case as a precedent.

A bold tax practitioner might attempt to make use of the idea that subsection 84(2) could be avoided by having the accommodator pay for the shares with assets that are different from the assets in the corporation being stripped, given the importance placed by the courts in *Tremblay* on the fact that the Vidéotron subordinated common shares were not legally identical to the Vidéotron convertible preferred shares and debentures.

This type of planning would require different non-cash assets in both the corporation being stripped and the accommodator corporation, and likely could only be defended successfully if there was substantial continuity of ownership of those assets by all parties both before and after the series of transactions. Converting assets to or from cash as part of the series likely would not avoid the assets being treated as fungible, and structuring a transaction that would withstand reasonable scrutiny might be impractical.

Sections 84.1 and 212.1 in Accommodation Transactions

It is interesting to observe how the courts have approached the issue of whether the accommodator corporations in these transactions are dealing with the share vendors at arm's length as a question of fact. The two leading cases are *McNichol* [104] and *RMM Enterprises*, [105] which are at odds with each other just as they were in the context of subsection 84(2), with *McNichol* favouring the taxpayer and *RMM Enterprises* the fisc. The difference is that the *McNichol* approach appears to be winning out in the section 84.1 /212.1 context.

The facts in both cases were substantially the same: the corporation to be stripped owned no significant assets other than cash; [106] the accommodation corporations were formed by arm's length business associates of the share vendors; bank financing in the form of daylight loans was arranged by the accommodator in both cases to satisfy the purchase price for the shares; the corporations that were stripped were wound-up and their assets used to repay the bank loans owing by the accommodator corporations and; the accommodator corporations in both cases profited from the transactions.

The Tax Court of Canada in *McNichol* considered the three tests for factual non-arm's length status (common mind, acting in concert and *de facto* control of one party by the other) and concluded that the share vendors were at arm's length with the accommodator corporation as a question of fact. The Tax Court found that the parties had divergent interests in the transaction, their actions in negotiating the share sale transaction were governed by their perceptions of their own self interest and nothing else, and the fact that the transactions were driven by the tax savings was not material. [107] The following passage from the reasons for judgment illustrates the factual considerations that were important to the result:

> The evidence in the present case shows that arm's length bargaining was present in the sale of the Bec shares. The interests of vendors and purchaser were divergent with regard to the purchase price. The appellants were clearly price sensitive for they terminated discussions with regard to the sale of the shares to a prospective purchaser, Malcolm Dunfield, upon learning that Forestell would pay a higher price. Conduct of overriding importance in establishing that the purchaser dealt with the appellants at arm's length, is Mr. Forestell's action in consulting Mr. Haylock, his own accounting and tax adviser, before committing Beformac to the transaction. At Mr. Forestell's request Mr. Haylock reviewed the situation and gave his opinion on the transaction from the point of view of Mr. Forestell. The actions of the appellants and Mr. Forestell in negotiating the share sale transaction were clearly governed by their respective perceptions of their own self-interest and nothing else. The fact that the tax savings potentially accruing to the appellants as a consequence of sale formed not only the reason for the sale but also the boundaries within which sale price might be negotiated does not suggest that the appellants and Forestell acted in concert. Buyer and seller do not act in concert simply because the agreement which they seek to achieve can be expected to benefit both. [108]

In *RMM Enterprises*, the Tax Court of Canada reached the opposite conclusion. The Court acknowledged that there was arm's length bargaining about the return the accommodator would realize on the transaction, but found that once the deal was settled the accommodator "had no independent role" in carrying out the transaction and was either acting in concert with or being controlled by the directing mind of the share vendor. [109]

Tom Stack made the observation in his 1997 conference paper discussing *RMM Enterprises* [110] that the Tax Court's analysis in is not consistent with *Windsor Plastic Products Ltd. v. R.* [111] where it was noted that the time to test the arm's length nature of a relationship is at the outset:

> Close control may endure for a long time throughout the extent of the arrangement, but since most contractual relationships or similar arrangements tend by their very nature and purpose to bind their participants into dealings of closer proximity than "arm's length," the critical time for the exercise or discernment of non- arm's-length dealing is truly at the inception of the questioned relationship. [112]

The *McNichol* approach has since been followed by the Tax Court in *Brouillette* [113] and *McMullen*. [114] We are not aware of any cases in which the section 212.1 analysis from *RMM Enterprises* has been followed, and it appears the better view is that an accommodation transaction likely can be implemented with a good degree of comfort that sections 84.1 and 212.1 should not apply.

The Crown successfully applied section 84.1 in two other cases that can best be described as failed accommodation transactions. These are not examples of the *RMM Enterprises* approach being favoured over *McNichol*, but of cases where the manner in which the plans were executed caused the parties not to be dealing at arm's length as a question of fact. They illustrate that it is important not only to understand the technical requirements of these transactions (in this case, the need for the vendor and the purchaser to be dealing at arm's length), but also to execute meticulously.

In *Lauzier v. R.*, [115] the taxpayer's accountant incorporated an accommodator corporation to buy the taxpayer's shares of a corporation which held cash and an entitlement to a tax refund. The accountant also appointed himself as a director of the corporation being stripped, appointed himself as its accountant, backdated the documents and represented the interests of both the accommodator corporation and the corporation being stripped. The Tax Court found that the parties were acting in concert, with the accountant as the common link, and therefore the taxpayer was not dealing at arm's length with the accommodator corporation. [116]

In *Côté-Létourneau c. R.*, [117] the taxpayers (husband and wife) tried to execute an arm's length accommodator transaction using an accommodator corporation controlled by a trust of which the taxpayers and their accountant were the trustees. The Tax Court found that, although the trust deed required unanimity among the trustees, the accountant had not, in fact, been involved in the decision making, and the two spouses were the common mind directing the bargaining both for themselves and the accommodator corporation. [118]

The GAAR in Accommodation Transactions

The CRA used the GAAR as an alternative assessing provision in four of the accommodation cases that have been litigated so far in the GAAR era: *McNichol,* [119] *RMM Enterprises,* [120] *Brouillette* [121] and *McMullen*. [122] The courts upheld the application of the GAAR in *McNichol* and *RMM Enterprises*, and ruled that the GAAR did not apply in *Brouillette* and *McMullen*. After *McNichol* and *RMM Enterprises* were decided, there was a fundamental change in the approach taken by the Courts to misuse and abuse analysis under subsection 245(4) following the decision of the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. R.,* [123] and those cases are no longer good law in the GAAR context.

The first of the GAAR cases to be decided was *McNichol*, in which the Tax Court ruled that the accommodation transaction resulted in a misuse of sections 38 and 110.6 and an abuse of the provisions of the Act, read as a whole. [124] The Court referred to subsection 12(1)(j) and sections 15 and 84 as legislative measures illustrating a scheme in the Act contemplating that distributions of corporate property to shareholders are to be treated as income in the hands of the shareholders, and concluded that transactions designed to effect, in everything but form, a distribution of corporate surplus constitute an abuse for the purposes of section 245. [125]

In *RMM Enterprises*, the Tax Court approved of and followed the GAAR analysis in *McNichol*, subject to the qualification that the Act, read as a whole, envisages that a distribution of corporate surplus to shareholders is to be taxed as a payment of dividends (as opposed to the more general reference to "income" in *McNichol*). [126]

Shortly after the Supreme Court of Canada released its decision in *Canada Trustco*, the Tax Court of Canada heard a GAAR case called *Evans v. R.* [127] In which the taxpayer transferred shares of a dental hygiene corporation to a partnership of which his three minor children were the 99% partners. The taxpayer used his capital gains deduction to shelter the capital gain from the sale of the shares, and over a period of years the dental hygiene corporation paid dividends to the partnership that were used to fund the share purchase price. The dividend income was reported by the taxpayer's children on their T1 income tax returns. Very little income tax was paid on the dividends because the transactions predated the introduction of the kiddie tax in section 120.4 .

The Crown argued in *Evans* that the GAAR should apply based on *McNichol* and *RMM Enterprises*, on the theory that the transactions resulted in the same type of surplus stripping abuse that had been perpetuated in those cases, with the partnership simply taking the place of the accommodator corporation as the vehicle for allowing the taxpayer to remove surplus in the form of a capital gain.

The Tax Court in *Evans* ruled that the GAAR did not apply, because the Court did not view the transaction as a surplus strip, but rather as an income splitting arrangement. [128] In a surplus stripping transaction, the payment of dividends to individuals is avoided. In *Evans*, dividends were paid to the partnership and taxed in the hands of individual taxpayers, but were not taxed because those taxpayers were in a low tax bracket. [129]

The Tax Court stated further that *McNichol* and *RMM Enterprises* may have been decided differently if the Tax Court had the benefit of the Supreme Court of Canada's guidance from *Canada Trustco* when it decided those earlier cases. [130] The Tax Court in *Evans* interpreted *Canada Trustco* as prohibiting reliance on an "overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends" while ignoring specific sections of the Act that provide otherwise. [131]

Since *Evans*, the Courts have confirmed in multiple cases that reliance on a general policy against surplus stripping is inappropriate to establish abusive tax avoidance. [132] The basis on which the GAAR was found to apply to accommodation transactions in *McNichol* and *RMM Enterprises* appears to have been conclusively overruled by the subsequent jurisprudence. The question for future cases is whether the application of the GAAR to accommodation transactions can be justified on some other basis.

In *McMullen*, the only case involving an accommodation transaction to be heard since *Evans*, the Tax Court of Canada ruled that the GAAR did not apply to prevent the taxpayer from realizing a capital gain (sheltered by the capital gains deduction) on a sale of shares of a corporation (DEL) to an arm's length corporation. The share sale was implemented as part of a reorganization in which the assets of DEL, consisting of two separate branches of a heating and air conditioning business, were split up into separate corporations so that the former 50/50 shareholders of the DEL could sever their business relationship.

In reaching its conclusion that the GAAR did not apply to convert the taxpayer's capital gain into a dividend, the Tax Court of Canada found that there is no general policy in the Act requiring corporate distributions to be taxed as dividends:

> In conclusion, the respondent has not persuaded me, or has not presented any evidence establishing, that there was any abuse of the Act read as a whole, or that the policy of the Act read as a whole is designed so as to necessarily tax corporate distributions as dividends in the hands of shareholders. In any event, as the Supreme Court of Canada has said, "[i]f the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer"...

However, the comfort that can be taken from this finding of the Tax Court may be limited based on other comments the Court made in its subsection 245(4) analysis which indicate that the Court viewed the transactions as a tax-effective solution for achieving the commercial objective of splitting DEL into two distinct businesses. [133] The Court commented that "there was a genuine change in the legal and economic relations between the two former shareholders in DEL," [134] and that the Act does not require taxpayers to structure commercial transactions so as to maximize the resulting taxes payable. [135]

There has not been a case decided since *Evans* involving an accommodation transaction undertaken for the sole purpose of monetizing a shareholder's capital gains deduction, and it remains to be seen whether the Courts in such as case will confirm that *McNichol* and *RMM Enterprises* were wrongly decided and such transactions are not abusive, or will find a basis for applying the GAAR that is consistent with the Supreme Court of Canada's guidelines in *Canada Trustco*.

In *Brouillette*, [136] which predates *Evans*, the Tax Court of Canada ruled that the GAAR did not apply to a leveraged buyout of a corporation (Brouillette Automobiles) that operated an automobile dealership. Two arm's length individuals wanted to purchase Brouillette Automobiles to operate the dealership as a going concern. They incorporated a corporation (9017) which purchased the taxpayer's shares of Brouillette Automobiles, and 9017 paid for the shares with a non-interest bearing demand note. The CRA assessed pursuant to subsection 84.1(1) on the basis that the taxpayer was not dealing at arm's length with 9017, and applied the GAAR in the alternative.

The Tax Court in *Brouillette* found that the taxpayer was dealing at arm's length with 9017, as the evidence established without a doubt that the interest of 9017's shareholders were totally separate from those of the taxpayer. [137] The Court then stated firmly that the GAAR could not apply if section 84.1 did not apply:

> Can section 245 of the Act apply to the case at bar? The respondent did not refer to any basis of taxation other than to section 84.1 of the Act. In my view, when the evidence shows that the parties were dealing at arm's length, the legal debate is closed. To hold that section 245 of the Act applies would be to legislate. The respondent stated that the purpose of the Act was to avoid corporate surplus stripping. If so, the respondent would have needed to point to an applicable section of the Act other than section 84.1. [138]

As section 84.1 is the specific anti-avoidance provision aimed at preventing a shareholder from cashing out his or her capital gains deduction by selling shares to an accommodation corporation, a reasonable argument can be made based on *Brouillette* that an arm's length transaction that does not fall within the scope of section 84.1 should not be considered abusive.

Pipeline Transactions

A "pipeline transaction" involves a transfer of shares that have low PUC and high ACB to a holding corporation in exchange for a promissory note or high PUC/high ACB shares of the holding corporation to create a "pipeline" of debt or high-PUC shares that can be used to transfer corporate assets to the shareholders without further tax payable by the shareholders. [139]

Some common reasons for implementing pipeline transactions are as follows:

1. In post-mortem planning, to avoid double taxation of future distributions on the low PUC/high ACB shares held by the estate, it is common to consider a pipeline strategy as an alternative to a subsection 164(6) share redemption and loss carryback strategy. Factors that influence this

decision include balances such as GRIP, CDA and RDTOH that may dictate a preference for subsection 164(6) planning, or the availability of a bump on non-depreciable capital property of the corporation, in which case the pipeline strategy may yield a better integrated tax result.

2. If a shareholder has purchased shares from an existing shareholder rather than from treasury, the ACB of the shares likely will exceed the PUC. Provided that the ACB is "hard" for the purposes of section 84.1, the pipeline strategy can be used to convert the hard ACB into a shareholder loan that can be repaid to the shareholder without further tax consequences.

3. A pipeline transaction can be used to extract funds from a corporation at capital gain rates rather than dividend rates in cases where there is a significant preference for capital gain rates (for example, if there is no GRIP balance in the corporation) or the shareholder has capital losses that can be used to offset the capital gain that will be triggered in the pipeline transaction.[140]

4. Taxpayers have attempted, so far without success, to use varieties of pipeline transactions to cash out capital gains deductions or V-Day increment in a manner that circumvents section 84.1.

Pipeline transactions, as we conceive of them, are non-arm's length transactions in which the shareholder typically controls both the original corporation and the new corporation that is used to implement the pipeline. We believe this distinction between pipeline transactions and accommodation transactions, in which the share purchaser is an arm's length corporation, is meaningful to the misuse and abuse analysis in the GAAR cases, and this is why we have analyzed the pipeline cases separately from the accommodation transaction cases.

The jurisprudence dealing with pipeline transactions has involved the potential application of subsection 84(2) and the GAAR. Section 84.1 has not been considered outside of the GAAR context, which is not surprising because the application of that provision to a standard pipeline transaction is technically straightforward and based on bright-line tests (unlike the accommodation transactions, there is no question that the parties to a pipeline transaction do not deal at arm's length).[141]

The recent subsection 84(2) jurisprudence unfortunately makes pipeline planning into a less straightforward exercise than it should be, particularly in contexts such as post-mortem planning and extraction of purchased "hard" ACB, where the pipeline transaction is a necessary tool to avoid double taxation that otherwise would result due to the fact that PUC, not ACB, dictates how much corporate surplus can be distributed to shareholders without triggering deemed dividend treatment. However, a clear consensus seems to be developing in support of the idea that a pipeline transaction will not be considered abusive for GAAR purposes if the shareholder has not cashed out his or her capital gains deduction or V-Day increment.

In contrast, most taxpayers who have used a variation of a pipeline transaction to extract surplus under the shelter of a capital gains deduction or V-Day increment have lost their GAAR appeals, and it appears that trend will continue.

Subsection 84(2) in Pipeline Transactions

Deemed dividend treatment under subsection 84(2) is the major risk in a pipeline transaction, and the same concerns that were discussed above in the context of accommodation transactions must be addressed. The biggest concern is that he broad "appropriated in any manner whatever" language in subsection 84(2) potentially allows the transfer of the low PUC/high ACB shares of the original corporation to the pipeline corporation to be treated as a step in the winding-up process of the original corporation and not as a separate transaction.

This was the issue that led to the undoing of the tax planning in *MacDonald*, [142] which is now the leading case regarding the application of subsection 84(2) to pipeline transactions. Given the state of the jurisprudence that was developed in the accommodation cases, the outcome in *MacDonald* is not surprising, and understanding why the facts in *MacDonald* created the result is the key to avoiding deemed dividend treatment under subsection 84(2) when structuring a pipeline transaction.

In *MacDonald*, the taxpayer was a medical doctor who wanted to wind up his medical professional corporation (PC) before emigrating to the United States. He had capital losses carried forward from prior years, and therefore preferred to realize the value of his PC shares in the form of a capital gain as opposed to a dividend. A pipeline transaction was chosen, and it is worthwhile to pay particular attention to the steps that were used, to observe the structural elements that caused subsection 84(2) to apply. Except where otherwise stated, all the transactions listed below occurred on the same day.

1. The first step was a sale of the PC shares to the taxpayer's brother-in-law (JS) in exchange for a promissory note of $525,068. JS then transferred the shares to a numbered corporation (601) that had been incorporated for the purpose of the pipeline, also in exchange for a note payable of $525,068. The PC shares had low PUC ($101), and the intervening transfer to JS avoided the deemed dividend under section 84.1 that would have resulted had the taxpayer transferred the PC shares directly to a non-arm's length corporation in exchange for a promissory note. [143]
2. The assets of the PC consisted of cash and a shareholder loan due from the taxpayer of $159,842.
3. PC distributed the bulk [144] of its funds to 601 by declaring and paying dividends. The dividends were paid using cheques payable to 601.
4. 601 endorsed the cheques to JS in satisfaction of the note payable to JS for the purchase of the PC shares, and JS endorsed the cheques to the taxpayer in satisfaction of his note payable to the taxpayer. One of the cheques was set off against the taxpayer's shareholder loan due to the PC.
5. The PC prepared articles of dissolution about one month after the transactions were implemented, but the PC was not officially dissolved until about three years later.

The taxpayer reported a capital gain from the sale of his PC shares that was offset by capital losses on his income tax return. The CRA reassessed on the basis that subsection 84(2) applied, and in the alternative relied on the GAAR (the Tax Court's reaction to the Crown's GAAR arguments will be discussed below).

The taxpayer was successful in the Tax Court of Canada on both the subsection 84(2) issue and the GAAR issue, but the Federal Court of Appeal reversed the Tax Court's decision on the basis that subsection 84(2) applied. [145] As discussed above, [146] the Federal Court of Appeal preferred the *RMM Enterprises* approach to subsection 84(2), in which the share sale to JS was treated as a complementary transaction to the dissolution of the PC, and not as a distinct transaction.

Based on that interpretation of the law, it was impossible to escape the conclusion that subsection 84(2) applied given that the taxpayer was paid using the PC's assets (which typically is the case in a pipeline transaction as there is no third party accommodator that can potentially pay the share vendor with property that did not belong to the corporation that is being wound-up). The facts In *MacDonald* were about as unfavourable as they could be, given the timing of the transactions which resulted in the taxpayer being paid for his PC shares using assets of the PC on the same day as the share sale. It is not difficult to understand why the Federal Court of Appeal concluded that funds of the PC had been appropriated "in any manner whatever" by the taxpayer on the winding-up of the PC.

As discussed above, the Federal Court of Appeal's decision in *MacDonald* appears to conclusively settle the question of whether a share sale to an accommodator or pipeline corporation can be viewed as complementary to the winding-up of a corporation: the answer is that, in appropriate circumstances, it can. This unfortunately creates uncertainty for tax practitioners, as it means that subsection 84(2) - a provision of broad and somewhat uncertain application - must be navigated when executing a pipeline transaction.

The CRA has issued favourable advance rulings on pipeline transactions on the basis that subsection 84(2) can be avoided by creating a time lag of at least one year between the share sale to the pipeline corporation and the liquidating distribution of corporate assets to the shareholder.[147] The Tax Court of Canada criticized this practice in *MacDonald* as an arbitrary contrivance that is not invited by the express language in subsection 84(2),[148] but the recent decision of the Tax Court of Canada in *Descarries*[149] suggests that manipulating the timing of the steps in the pipeline can allow subsection 84(2) to be avoided.

In *Descarries*, the taxpayers used a pipeline transaction to liquidate a corporation (Oka) that had formerly owned real estate, but at the time of the transactions held mostly cash. The issued and outstanding shares of Oka had a fair market value of $617,466, ACB of $361,658 and PUC of $25,100. It appears that all but $92,040 of the ACB was "soft" for the purposes of section 84.1, and the pipeline was structured in a manner that allowed the soft ACB to be cashed out without income tax consequences.

1. A pipeline corporation (9149) was incorporated, and Oka loaned it $544,354 (presumably in cash). This was done on December 1, 2004, and the next steps in the transaction did not take place until March, 2005.

2. On March 1, 2005, the taxpayers exchanged their issued and outstanding shares of Oka for two classes of preferred shares of Oka, pursuant to an internal subsection 85(1) reorganization. The taxpayers elected to receive proceeds of disposition equal to the fair market value of the Oka shares ($617,466), and as a result realized capital gains totalling $255,808. As a result of this transaction, their Oka preferred shares had an ACB of $617,466, but $269,618 of that ACB was still "soft" for subsection 84.1 purposes.

3. On March 15, 2005, the taxpayers transferred their Oka preferred shares to 9149 in exchange for two classes of preferred shares of 9149 having an aggregate redemption amount of $617,466 and aggregate PUC of $347,848. Section 84.1 applied to prevent the "soft" ACB of $269,618 from being added to the PUC of the preferred shares issued by 9149.

4. On March 29, 2005, 9149 redeemed most of the preferred shares held by the taxpayers ($544,354 worth). The taxpayers received $347,848 tax-free on the redemption of the class of 9149 preferred shares that had PUC in that amount, and realized deemed dividends totalling $196,506 on the redemption of the other preferred shares, which had no PUC. The taxpayers also realized capital losses totalling $196,506 on the redemption of the low PUC preferred shares, and the capital losses were deducted against the capital gains that were triggered on the internal subsection 85(1) reorganization in step 2.

5. Winding-up resolutions for Oka were not passed until December 15, 2006, as it took some time for Oka to sell of the last of its real estate assets. As of the date of the winding-up resolutions, Oka still held the debt of $544,354 due from 9149 that was created in step 1, and this was material to the Tax Court's finding that subsection 84(2) did not apply.

6. At the end of 2008, the taxpayers still held 73,112 low PUC preferred shares of 9149. Those shares were redeemed for $69,000, resulting in deemed dividends and capital losses.

The CRA reassessed the taxpayers pursuant to subsection 84(2) and the GAAR. The Tax Court held that subsection 84(2) did not apply, but that the GAAR did apply on the basis the transactions resulted in an abuse of section 84.1. The Tax Court allowed the taxpayers to extract their "hard" ACB of $92,040, but the remaining $525,422 of cash that was pipelined through 9149 was taxed as deemed dividends. The GAAR aspect of the decision is discussed below.

In analyzing subsection 84(2), the Tax Court in *Descarries* considered the Federal Court of Appeal decision in *MacDonald*, as well as the decision of the Supreme Court of Canada in *Merritt*, and observed that in those cases there was no doubt that the winding-up, discontinuance or reorganization of the corporation was concurrent with the distribution of corporate assets to the shareholder. [150] In *MacDonald*, as discussed above, everything happened on the same day.

The Tax Court in *Descarries* found that the relevant time for considering whether subsection 84(2) applied was March, 2005, because that was when the first (and biggest) payment was made to the shareholders. [151] As of that date, Oka's assets had not been depleted, because it had loaned its cash to 9149 and held a $544,354 note payable by 9149 that was not extinguished until Oka was wound-up in 2006. The Tax Court in *Descarries* distinguished *Merrit*and *MacDonald* on the basis that Oka had not been stripped of its assets as of March, 2005 because it was a creditor under the loan to 9149, and therefore did not apply subsection 84(2). [152]

The Tax Court also noted that Oka had not completely liquidated its real estate holdings as of March, 2005, [153] and this was also a factor in the Court's determination that the $544,354 distribution that the CRA sought to tax as a deemed dividend in 2005 (being the $544,354 of share redemption proceeds received by the taxpayers from 9149) was not concurrent with the winding-up of Oka's business, which did not occur until 2006. The Court interpreted *Merritt* and *MacDonald* as requiring the distribution to be concurrent with the corporate event (winding-up, discontinuance or reorganization of the business) that triggers the application of subsection 84(2), and this observation seems to be consistent with all of the previous subsection 84(2) jurisprudence.

Because the $544,354 that was used to fund the main share redemption in March, 2005 was advanced from Oka to 9149 as a loan rather than being distributed as a dividend (as was done in *MacDonald*), the transaction structure in *Descarries* allowed the taxpayers to create a delay of about 18 months between the receipt of the funds by the shareholders and the winding-up of Oka, which did not occur until December, 2006. This aspect of the Tax Court's decision in *Descarries*is not inconsistent with any of the previous subsection 84(2) jurisprudence, and it may be possible to use this technique to avoid the application of subsection 84(2) in pipeline transactions.

The GAAR in Pipeline Transactions

The results in the GAAR jurisprudence to date involving pipeline transactions depend on whether the taxpayers have cashed out their capital gains deductions, V-Day increment or "soft" ACB as part of the series of transactions. In cases where capital gains deductions, etc. are not involved, the Courts have ruled that pipeline transactions are not abusive. In GAAR cases involving capital gains deductions, the taxpayers have lost every time.

The GAAR cases in which taxpayers have been successful include the Tax Court of Canada decision in *MacDonald* [154] and *Collins & Aikman*. [155]

In *MacDonald*, the taxpayer attempted to use a pipeline transaction to realize the value of the shares of his PC in the form of a capital gain, before emigrating to the United States. The taxpayer had capital losses that could be used to offset the capital gain, and therefore preferred not to straightforwardly wind-up the PC, which would have resulted in dividend treatment.

The Tax Court of Canada held that the taxpayer's use of capital losses to offset the capital gains realized in the pipeline transaction was not abusive (the Court considered the idea "bizarre" given that the taxpayer could have achieved this result simply by emigrating). [156]

Although the tax planning in *MacDonald* did not involve an arbitrage of capital gain rates vs. dividend rates, the Court acknowledged that this could be a motive for engaging in a pipeline transaction, and made a statement of general application that such planning should not be considered abusive. In the Court's words:

> The tax avoidance and tax benefit resulting from a lack of integration in this case is systemic. There is no unintended tax slippage in this sense, and in such circumstances GAAR cannot be used to prevent a tax planned approach to accessing retained earnings. Said differently, neither subsection 84(2) nor GAAR can be used to fill a gap between two approaches to taxing an individual shareholder's realization of accumulated after-tax funds in a company. [157]

In *Collins & Aikman*, the taxpayer was a US-resident corporation (Products) that owned shares of another non-resident corporation (CAHL), which in turn owned shares of a Canadian-resident corporation that had a value of $167 million. Products transferred its shares of CAHL to a new, Canadian-resident holding corporation (Holdings) in exchange for a single share having PUC of $167 million. The transfer of the CAHL shares to Holdings was not subject to Canadian income tax because the shares of CAHL were not taxable Canadian property, and section 212.1 did not apply because CAHL was a non-resident corporation. Following these transactions, Holdings distributed $104 million to Products as a tax-free return of capital, and the CRA reassessed pursuant to the GAAR on the basis that Part XIII tax should have applied to those distributions.

The Tax Court of Canada allowed the taxpayer's appeal, and the Federal Court of Appeal affirmed the Tax Court's decision. In the Tax Court, the Crown appears to have advanced the *McNichol*and *RMM Enterprises* arguments that the scheme of the Act dictates that corporate distributions are to be taxed as income, but the Court did not agree with that approach.

> In essence, the most significant part of this analysis is the determination of what is the scheme of the Act applicable to corporate distributions. Is the scheme of the Act, as maintained by the Crown, that corporate distributions are to be included in income except where specific provisions of the Act provide otherwise in particular circumstances or to a particular extent? Or does the scheme of the Act, of which subsection 84(4) forms part, provide that (i) dividends distributed by corporations are included in income except in circumstances where, or to the extent that, the Act provides otherwise, and that (ii) distributions to shareholders by corporations other than by way of dividend are included in income to the extent only that they exceed the shareholders' paid-up capital in those shares, subject to specific rules which provide otherwise in certain circumstances or to a certain extent?
>
> The difference between these two competing schemes is that in the Crown's mind this scheme begins from an unstated premise not vocalized in the language of the Act that corporate distributions are income. The Crown then goes on to treat the opposing theory, which is grounded or anchored in specific starting point provisions of the Act, as exceptions to its generalized starting point. In either case, subsection 84(4) forms part of the scheme of the Act relating to the taxation of corporate distributions.
>
> ...

> I do not accept the Crown's view. When considering the statutory provisions dealing with corporate distributions there is no clear need to step back from the Act altogether, begin from an unstated premise, and then treat the Act as only setting out the exceptions. Sections 82, 112 and 121, and subsection 84(4) are drafted as the starting points for determining how corporate dividends and other corporate distributions respectively are to be included in income. Subdivision h of the Act is drafted as a régime, not as a series of exceptions. [158]

The Tax Court then reviewed the post-*Canada Trustco* jurisprudence in *Evans, Copthorne Holdings*, and *McMullen*, in which the Courts held that there is no scheme in the Act that dividend or surplus stripping should not be allowed, contrary to the earlier decisions of the Tax Court in *McNichol*and *RMM Enterprises*. [159]

The Federal Court of Appeal in *Collins & Aikman* agreed with the Tax Court decision, substantially for the reasons given in the Tax Court. [160] The decisions of the courts in *MacDonald* and *Collins & Aikman* provide strong support for the conclusion that pipeline transactions generally should not be considered abusive for GAAR purposes.

The GAAR outcome becomes a different matter in cases where pipeline transactions are used to monetize capital gains deductions, V-Day increment or "soft" ACB without the involvement of an arm's length accommodation party.

In *Nadeau v. R.* out="0" hidden="0"> </CHARFORMAT> the taxpayer crystallized the accrued capital gain on her shares of a holding corporation (Holdings) pursuant to an internal subsection 85(1) share exchange, and used her capital gains deduction to offset the resulting capital gain. A second corporation owned by the taxpayer's son then used a daylight loan to subscribe for a single share of Holdings of the same class as the taxpayer's shares, which resulted in PUC averaging that increased the PUC of the taxpayer's shares such that the PUC of the shares was equal to their ACB. The taxpayer's shares were then redeemed tax-free. The Tax Court of Canada held that this was abusive based on the then-prevailing jurisprudence in *McNichol*and *RMM Enterprises* which was based on the theory that there is a general scheme in the Act against surplus stripping.

In *Desmarais v. R.,* out="0" hidden="0"> </CHARFORMAT> the taxpayer held shares of two corporations. In one of the corporations, (Comerscom) he held a minority interest of 9.76%, and he transferred these shares to a holding corporation (6311) on a taxable basis in exchange for high PUC/high ACB shares of 6311, and claimed the capital gains deduction. Section 84.1 did not apply because 6311 was not connected with Comerscom following the share transfer for the purposes of Part IV.

The taxpayer then transferred shares of a second corporation (Gestion) to 6311 on a rollover basis pursuant to subsection 85(1). The taxpayer was related to Gestion for tax purposes, as he and his brother each owned 50% of the shares of that corporation. Gestion then paid dividends to 6311 that were used by 6311 to redeem the taxpayer's high PUC/high ACB preferred shares that had been issued by 6311 in exchange for the taxpayer's Comerscom shares.

The Tax Court of Canada in *Desmarias* held that the transactions resulted in an abuse of section 84.1. The surpluses that were stripped came from Gestion, and the transfer of the Comerscom shares to 6311 was viewed by the Court as a mechanism for circumventing section 84.1 which otherwise would have prevented the surpluses of Gestion from being distributed tax-free in a conventional pipeline transaction. [163]

In the recent *Descarries* case, [164] the taxpayers owned shares of a corporation (Oka) that had a substantial amount of "soft" ACB. The taxpayers structured their pipeline transaction such that they realized a capital gain (not sheltered by the capital gains deduction) on some of their Oka shares to create a high PUC/high ACB pipeline, and then redeemed the shares that had "soft" ACB to generate a capital loss that was used to offset the capital gain that created the tax-free pipeline.

The result of the transactions in *Desmarais* was that the taxpayers were able to use their "soft" ACB in a non-arm's length transaction to shelter a portion of the proceeds received on the liquidation of Oka. The Tax Court held that this resulted in an abuse of section 84.1. [165]

Unlike the transactions involving arm's length accommodation parties, in which some taxpayers (*Brouillette, McMullen*) have been able to cash out their capital gains deductions without being offside of the GAAR, the non-arm's length pipeline strategies have been uniformly unsuccessful, and the Courts have developed new abuse theories based specifically on section 84.1 since the *McNichol*and *RMM Enterprises* cases fell out of favour. It appears that cashing out capital gains deductions using variations of the non-arm's length pipeline strategy will continue to be a high risk endeavour.

Hybrid Asset/Share Sale Transactions

A hybrid asset/share sale transaction is an arrangement that is either identical to, or based on, the planning undertaken in *Geransky v. R.* [166] The purpose of these arrangements is to permit the shareholders of a CCPC to utilize their capital gains deductions on an asset sale by the corporation, thereby reducing the effective integrated corporate-shareholder rate of tax on the asset sale by eliminating the need to distribute after-tax cash by paying taxable dividends.

The implementation of a hybrid asset/share sale has been the topic of other papers, [167] and the implementation of the *Geransky* transactions is usefully summarized by Bowman A.C.J.T.C. (as he then was) in his reasons. [168] In its simplest form, where the shareholders of the target CCPC ("**Target**") are individuals, the hybrid asset/share sale will involve the following steps:

1. The acquirer will incorporate a new subsidiary ("**Acquireco**") to complete the purchase of the Target assets, and will contribute the necessary capital to Acquireco.

2. The shareholders of Target will "crystallize" their capital gains deductions by exchanging a portion of their Target common shares having a FMV of up to $800,000 for redeemable, retractable voting preferred shares of Target with a redemption amount equal to the FMV of the exchanged common shares. These preferred shares will have low stated capital. The shareholders of Target will elect to transact for FMV proceeds under subsection 85(1) .

3. The shareholders of Target will sell their preferred shares of Target to Acquireco in exchange for cash. No gain or loss will be realized by the Target shareholders on this disposition.

4. Target will repurchase its preferred shares in exchange for a non-interest bearing promissory note. This redemption should give rise to a subsection 84(3) deemed dividend, which dividend should be deductible by Acquireco under subsection 112(1) . Subsection 55(2) should not apply to this dividend as there is no accrued capital gain on the Target preferred shares that is reduced by the repurchase.

5. Acquireco will purchase the assets of Target for consideration consisting of the cancellation of the Target promissory note and cash equal to the excess of the FMV of the Target assets over the principal amount of the Target promissory note.

6. Target will pay such capital dividends and taxable dividends as are necessary to distribute the cash received from Acquireco to its shareholders.

There are a few technical points that must be considered in implementing a hybrid asset/share sale, the most important of these being to ensure that Target and Acquireco are "connected" within the meaning in subsection 186(4) at the time that the Target preferred shares are repurchased. It is also necessary to ensure that neither Part IV.1 nor Part VI.1 tax will apply to the subsection 84(3) deemed dividend. These technical points are discussed in detail in the other papers cited above.

The jurisprudence relating to hybrid asset/share sale transactions is essentially limited to *Geransky*, which was decided in favour of the shareholders undertaking the hybrid asset/share sale. The CRA has accepted the result in *Geransky* and will not challenge "identical" transactions, [169] so the lack of jurisprudence relating to these relatively common arrangements presumably can be attributed to hybrid asset/share sales being accepted planning.

Subsection 84(2) in Hybrid Transactions

The reasons for the non-application of subsection 84(2) to the *Geransky* transactions were straightforward and are explained succinctly in the reasons of Bowman A.C.J.T.C. (as he then was). In *Geransky*, there were three reasons for the non-application of subsection 84(2):

1. There was no discontinuance, winding-up or reorganization of the Target business (Target sold only the assets used for manufacturing the cement used in its main business, which it continued to carry on);

2. The Appellant in *Geransky* was an indirect shareholder of Target, so even if there was a reorganization of the Target business, it had no bearing on the Appellant as a shareholder of a different corporation; and

3. The Appellant did not receive funds of either Target or the holding corporation in which he owned shares, nor did the Appellant receive fungible property through an accommodation party as in *Smythe* or *RMM Enterprises*. The property received was property of Acquireco, which was received in exchange for shares sold by the Appellant to Acquireco to facilitate Acquireco's acquisition of the Target assets.

The first reason for the non-application of subsection 84(2) will not be relevant in most situations, as Acquireco will be seeking to purchase substantially all of the assets of Target. The second reason may also be of questionable relevance following *MacDonald*, particularly if the indirect shareholder of Target became an indirect shareholder in the course of the series of transactions that includes the sale of the Target shares (or the shares of another corporation).

However, the third reason will be relevant in most instances, provided that Acquireco uses its own cash to fund the acquisition of the Target preferred shares and does not rely on cash obtained from Target on the repurchase of the preferred shares to pay the acquisition price. This is a reasonable result, as the assets purchased by Acquireco will typically not include cash, so the cash paid to the shareholders of Target is "new" cash, as in an ordinary share sale, so there is nothing that could have been appropriated by or distributed to the Target shareholders. There also is no reason to disregard the existence of Target and attribute the consideration for the Target shares to the Target assets.

This appears to be the same conclusion that the CRA has reached with respect to the application of subsection 84(2) to hybrid asset/share sales. Provided that: (a) Acquireco and Target deal at arm's length; (b) the cash used by Acquireco to acquire the Target shares is not obtained from Target;

and (c) the Target assets are used by Acquireco in a business, the CRA will not seek to apply subsection 84(2). However, the CRA might seek to apply subsection 84(2) if, as part of the series of transactions, some property of Target did end up in the hands of the Target shareholders.

Sections 84.1/212.1 in Hybrid Transactions

The authors conceive of the hybrid share/asset sale as an alternative structure for an arm's length transaction in circumstances where an asset sale would otherwise be appropriate, which structure would be the subject of hard bargaining by the vendor and purchaser. As such, and having regard for the variety of opposing economic interests that would be engaged, it would be difficult to conclude that share vendor and the share acquirer do not deal at arm's length. For this reason, neither section 84.1 nor section 212.1 typically should be of any application to a hybrid share/asset sale.

The GAAR in Hybrid Transactions

In *Geransky*, the GAAR did not apply to the hybrid transactions because the transactions were found to not be avoidance transactions and because there was no misuse or abuse of any relevant provision or of the Act read as a whole. The former conclusion is almost certainly incorrect in light of *Mackay v. R.*, so the non-application of the GAAR rests on the conclusion that the hybrid arrangement does not misuse or abuse the Act.

The decision in *Geransky* predates *Canada Trustco*, so Bowman A.C.J.T.C. (as he then was) did not have the benefit of the Supreme Court's guidance in identifying a misuse or abuse of the Act. That said, there is little reason to believe that the result in *Geransky* would be different if the case were decided after *Canada Trustco*. No provision is relied on to achieve an outcome that it is intended to prevent, no transaction defeats the underlying rationale of the provisions relied upon, and no anti-avoidance rule is circumvented in a manner that frustrates its purpose. Further, since there is no scheme of the Act relating to surplus stripping, it is unreasonable to argue that there has been a misuse or abuse of the Act as a whole.

In essence, Bowman A.C.J.T.C. (as he then was) correctly characterized the *Geransky* transactions as a commercial transaction completed in a creative manner so as to apply various provisions of the Act in accordance with their terms. This, as he notes, is precisely the situation in which the GAAR should not apply. The reasoning of Bowman A.C.J.T.C. has also been adopted in numerous post-*Canada Trustco* decisions, suggesting strongly that the same conclusions would be reached when the *Canada Trustco* analysis is applied.

Comments on Planning Options

All of the foregoing discussion is intended to assist the reader in understanding the authors' comments on some popular surplus stripping arrangements. The following discussion combines the technical requirements of the Act, the principles derived from the jurisprudence and an understanding of the underlying policy and legislative history to identify surplus stripping arrangements that should or should not be effective, and to suggest options for improving the structure of transactions that have historically been troublesome - particularly pipeline transactions and accommodator transactions.

Reasonable people may differ with the authors' conclusions as to the efficacy of these arrangements. It is not our objective to be authoritative; our more modest hope is that we have made a somewhat useful contribution literature in this area.

Pipeline Transactions

Subsection 84(2) historically has been the biggest risk factor for pipeline transactions, because of the concern that the share sale to the pipeline corporation may be viewed as a step in the winding-up process of the original corporation and not as a separate transaction. The downside if subsection 84(2) applies is that the shareholder will receive dividend treatment instead of capital gain treatment, and in the post-mortem context this can result in double taxation if a subsection 164(6) loss carryback is not available.

The Tax Court of Canada's decision in *MacDonald* gave tax practitioners a brief respite from subsection 84(2), but the Federal Court of Appeal decision has brought it back and we must now reacquaint ourselves with the administrative practices of the CRA and the planning techniques that must be used to avoid subsection 84(2) in pipeline transactions.

The CRA has issued a number of advance income tax rulings [170] on pipeline transactions confirming that subsection 84(2), section 84.1 and the GAAR will not apply in circumstances where the following conditions are met:

1. The original corporation's business will continue for at least one year following the implementation of the pipeline structure.
2. The original corporation will not be amalgamated or wound-up into the pipeline corporation for at least one year.
3. The original corporation's assets will not be distributed to the shareholders for at least one year, followed by a progressive distribution of the corporation's assets over an additional period of time.

Chris Falk and Stefanie Morand reviewed the CRA's administrative guidelines in their paper on pipeline planning from the 2012 Ontario Tax Conference, [171] and proposed the following list of best practices for pipeline transactions.

1. Where possible, it is preferable to fall within the circumstances described above in which the CRA has ruled favourably. If the size of the transaction merits it, consider obtaining an advance income tax ruling from the CRA.

2. Where it is not possible to follow the guidelines in the CRA advance rulings, consider structuring the pipeline transaction so that the assets of the original corporation are transferred to the pipeline corporation on a formal winding-up to which subsection 88(1) applies (as opposed to paying a dividend or amalgamating the original corporation and the pipeline corporation). Paragraph 88(1)(d.1) provides that subsection 84(2) does not apply to the winding-up of the subsidiary in a subsection 88(1) wind-up, and this arguably should create a technical argument for precluding the application of subsection 84(2) to the entire pipeline transaction.

   (a) This idea has never been raised in any of the subsection 84(2) jurisprudence, but we believe it has considerable merit. A wind-up can qualify for subsection 88(1) provided that the parent corporation owns at least 90% of the issued shares of the capital stock of the subsidiary, and therefore contemplates that there may be minority shareholders. Paragraph 88(1)(d.1) applies to all shareholders in a winding-up, not just the 90% parent, and it states clearly that subsection 84(2) "does not apply to the winding-up of the subsidiary."
   (b) In a pipeline transaction, a corporate event is required to trigger the application of subsection 84(2) (the winding-up, discontinuance or reorganization of the corporation's business). If the pipeline transactions are arranged such that the corporate event by which the assets of the original corporation are distributed to the pipeline corporation is a winding-up to which subsection 88(1) applies, it seems all affected parties (including the original shareholders and the pipeline corporation) should be in a position to rely on paragraph 88(1)(d.1), with the result that

subsection 84(2) should not affect the pipeline transactions.

3. If the CRA's administrative guidelines are not being followed in a post-mortem pipeline transaction, consider implementing the pipeline during the first taxation year of the estate so that subsection 164(6) may be relied on if the CRA seeks to apply subsection 84(2).

We agree that the above list is a good set of best practices for pipeline transactions following the Federal Court of Appeal's decision in *MacDonald*. Another planning option that could be considered if the CRA's guidelines are not being followed would be to replicate the transactions in *Descarries* (discussed above). [172]

In *Descarries*, cash held by the original corporation was loaned to the pipeline corporation and then used to repurchase preferred shares of the pipeline corporation (which was done at the outset of the pipeline transactions, not one year later as in the CRA's advance rulings). The original corporation was not formally wound-up for another 18 months, and retained the note payable by the pipeline corporation as an asset throughout that period.

The Tax Court of Canada found that the original corporation had not been "stripped" when it loaned its cash to the pipeline corporation, because it continued to have assets of the same value as before the pipeline was commenced. As a result, the distribution to the shareholders (which occurred at the outset of the transactions when the pipeline corporation redeemed the preferred shares held by the shareholders) was not concurrent with the winding-up or discontinuance of the business of the original corporation, which happened eighteen months later. As a result, subsection 84(2) did not apply.

A pipeline transaction that does not involve a non-arm's length cash-out of capital gains deductions, V-Day increment or "soft" ACB generally should not be considered abusive for GAAR purposes based on *Collins & Aikman* [173] and the Tax Court of Canada decision in *MacDonald*. [174]

Employee Buyco Arrangements

The so-called "employee buyco" arrangements comes in two flavours: vanilla, and aggressive. In a vanilla employee buyco structure, a group of employees will have acquired shares of a CCPC ("Opco") from treasury or from a founding shareholder, typically subject to a unanimous shareholder agreement ("**USA**") that requires the shares to be disposed of on the retirement, termination or death of the shareholder-employee. In order to permit the shareholder-employees to utilize their capital gains deduction on a disposition of the Opco shares, the controlling shareholder of Opco would incorporate a corporation ("**Buyco**") that would purchase the shares held by departing shareholder-employees at their FMV using money borrowed from Opco, causing the selling shareholder-employees to realize a capital gain.

It is difficult to conclude that this arrangement is surplus stripping in the traditional sense. Here, the departing shareholder-employees are not substituting a capital gain for a distribution of retained profits while retaining an economic interest in the assets and undertakings of Opco, but are instead realizing a capital gain on the complete termination of their interests in Opco. The value of the shares of Opco may be largely disconnected from its retained profits, and the Opco business will continue as a going concern in which other persons are economically interested to a greater degree than before. There is no particularly compelling policy reason why the shareholder-employees should be required to receive a dividend on the disposition of their Opco shares in these circumstances.

Indeed, it would seem that Parliament has recognized the potential unfairness of denying the departing shareholder-employees the opportunity to realize a capital gain such situations. Subsection 15(2.5) is intended to permit similar arrangements where an *inter vivos* trust ("**Buytrust**") borrows money from Opco to facilitate the purchase of shares from employees who are not "specified employees" for FMV proceeds, with such shares to be resold to other employees for FMV proceeds. [175] This is exactly what a vanilla "employee buyco" arrangement is intended to accomplish, but with a corporation (Buyco) substituted for Buytrust. If the realization of a capital gain funded by Opco's money by a departing employee is an acceptable result when Buytrust is used to facilitate purchases and shares of Opco, then it appears reasonable to conclude that this should be an acceptable result when Buyco acts as the facilitator.

The CRA had initially accepted the employee buyco arrangement, but announced at the 2012 CTF Annual Conference that it would no longer grant favourable rulings. In the CRA's view, the degree of accommodation provided to the employees by Buyco suggested strongly that the employees did not deal at arm's length with Buyco, such that subsection 84.1(1) could apply to the sale of shares. [176] In arriving at this conclusion, the CRA pointed to both *Petro-Canada* and *RMM*, the latter case featuring a finding that a facilitator party did not deal at arm's length for the purposes of applying subsection 212.1(1) .

In the authors' view, this conclusion is not reasonable in light of the post-*RMM* jurisprudence. In particular, the authors would point to *Remai Estate*, where a facilitator party with no financial interest in the transactions was found to deal at arm's length with the party wishing to enter into the transactions. If that degree of accommodation is arm's length dealing, then it is unclear why the accommodation by Buyco would not be; Buyco, as a member of the Opco corporate group, has a financial interest in the purchase of the shares from the shareholder-employee that is completely opposed to the financial interests of the departing shareholder-employees, and the Buyco transactions are typically required by a USA that the parties entered into freely, the terms of which would have been negotiated.

Moreover, the existence of subsection 15(2.5) suggests that Parliament believes that Buytrust arrangements are arrangements that arm's length shareholder-employees and their employer will seek to enter into. If, as the CRA contends, this identical degree of accommodation were indicative of a non-arm's length relationship between the employer and the shareholder-employee, subsection 15(2.5) would be rendered inoperative, as every shareholder-employee participating in the Buytrust would be a "specified employee" by virtue of that non-arm's length relationship. There is no convincing reason why the shareholder-employees and the employer would be sufficiently likely to deal at arm's length where a Buytrust is used to justify the enactment of subsection 15(2.5), but not sufficiently likely to deal at arm's length where a Buyco is used to justify reconcile the CRA's administrative position with a reasonable interpretation of subsection 15(2.5).

Where the CRA's concerns might be justified, however, is in respect of the "aggressive" employee buyco arrangement, which have been discussed elsewhere. [177] In a simple version of the aggressive Buyco arrangement, an employee of Opco will incorporate Buyco, and Buyco will borrow money from Opco and use that money to purchase shares from the controlling shareholder of Opco, who will claim his capital gains deduction. Buyco and Opco may then be amalgamated to eliminate both the Buyco shares of Opco and the Buyco debt owing to Opco, and with the employee receiving nominal value preferred shares on the amalgamation. The controlling shareholder of Opco would remain in control of Opco before, after and throughout the series of transactions, with his or her relative economic interests in Opco unchanged.

If the employee of Opco is ordered or otherwise compelled to complete the transactions by the controlling shareholder of Opco and does not realize any form of economic profit from his or her participation, then there may be a reasonable argument that the employee does not deal at arm's length with the employee by virtue of there being *de facto* control or a directing mind. While *Remai Estate* has set a relatively high standard for a facilitator party to not deal at arm's length with a party realizing the economic benefits of an arrangement involving the facilitator, evidence of actual compulsion would be sufficient to cause the aggressive Buyco structure to be a non-arm's length transaction, thereby attracting the application of subsection 84.1(1) .

GAAR would also be of concern in an aggressive employee buyco transaction even if the Buyco is found to be dealing at arm's length with the share vendor for the purposes of subsection 84.1(1). So far, nobody has won a GAAR case involving a share sale to an accommodator that was done for the purpose of cashing out the vendor's capital gains deduction. Some of the more recent GAAR jurisprudence suggests there is hope that this could successfully be accomplished, but in our view this likely would require a transaction structure that does not remotely flirt with subsection 84.1(1), involving an independent third party accommodator with the capacity and financial wherewithal to dictate terms, provide the funds for the share purchase, negotiate its compensation and cover its share of the transaction costs. The typical employee Buyco may lack some or all of these qualities.

Cashing out the Capital Gains Deduction

Surplus stripping transactions that are nakedly aimed at monetizing the capital gains deduction must, in our view, be viewed as high risk notwithstanding that the Courts have abandoned the concept that there is a general scheme in the Act against surplus stripping. This type of tax planning continues to be a major area of focus for the CRA - in the CRA's GAAR update published in 2013, [178] a significant number of the surplus stripping cases assessed pursuant to the GAAR in 2012 were non-arm's length "PUC fabrication transactions" designed to facilitate capital gains deduction monetization using a non-arm's length pipeline transaction.

To date, taxpayers have been successful in only three cases in which they arranged to cash out capital gains deductions.

In Brouillette, [179] the taxpayer sold shares of a corporation to an arm's length corporation and claimed his capital gains deduction. Given the finding of the Tax Court that the purchasers acquired the corporation for the purpose of operating its automobile dealership as a going concern, it is questionable whether the CRA should have even sought to apply section 84.1 , much less the GAAR. On the facts as found by the Court, there was no mischief.

In *McMullen*, [180] the share sale was implemented as part of a reorganization in which the assets of a corporation (DEL), consisting of two separate branches of a heating and air conditioning business, were split up into separate corporations so that the former 50/50 shareholders of the DEL could sever their business relationship. One of the former shareholders was able to convert a portion of his capital gains deduction into a shareholder loan of his new operating corporation in the course of the reorganization.

The Tax Court's subsection 245(4) analysis in *McMullen* indicates that the Court was not offended by the monetization of the capital gains deduction because it occurred as part of a commercial transaction (the split-up of DEL), and it is questionable whether the same result would apply in a case where cashing out the capital gains deduction is the only object.

The only Tax Court decision to date involving a true "naked" monetization of the capital gains deduction (with no underlying commercial purpose) is *Evans*. [181]*Evans* cannot properly be regarded as a surplus stripping case, because taxable dividends were paid to and reported by individuals (the taxpayer's children). "Income splitting" was the magic ingredient in *Evans*, not surplus stripping, and it cannot be assumed that the favourable result in that case would necessarily apply to a surplus stripping strategy involving an accommodation party or a non-arm's length pipeline transaction. While the *Evans* strategy probably could be replicated today with a reasonable prospect of surviving a GAAR challenge, the introduction of the kiddie tax in section 120.4 likely places a significant restriction on its effectiveness.

It is clear that the Courts have abandoned the idea originally expressed in *McNichol* and *RMM Enterprises* that there is a general scheme in the Act against surplus stripping. However, in cases such as *Descarries* involving non-arm's length cashout strategies, the Courts have developed new GAAR abuse theories based on section 84.1 .

There has not been a case since *McNichol* involving the use of an arm's length accommodation party for the sole purpose of monetizing capital gains deductions, and it remains to be seen whether the court will develop a new subsection 245(4) abuse theory to support the application of the GAAR in these types of cases, as was done in *Descarries*. Some comfort can be taken from *Brouillette,* in which the Tax Court stated that the GAAR should not apply to an arm's length transaction to which section 84.1 does not apply, but it is important to remember that the facts in that case did not disclose any mischief. [182]

1 See, for example, Mark Meredith and Jacqueline Fehr, "Surplus Stripping: In the Eye of the Beholder," *2013 British Columbia Tax Conference*, (Toronto: Canadian Tax Foundation, 2013), 14: 1-29; Ron Durand and Lindsay Gwyer, "Surplus Stripping and Domestic Private Corporations," *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 13:1-20; H. Heward Stikeman and Robert Couzin, "Surplus Stripping," (1995), vol. 43, no. 5 *Canadian Tax Journal*, 1844-1860; Michael J. O'Keefe, "Surplus Stripping After Tax Reform," *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 17:1-20.

2 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the "**Act**"). All statutory references contained in this paper are references to the Act unless otherwise noted.

3 Canada, *Report of the Royal Commission on Taxation*, vol. 6 (Ottawa: Queen's Printer, 1966), Chapter 19 and Appendix D.

4 *Ibid*., Chapter 19.

5 As noted by some academic commentators shortly after the 1971 tax reform, the effect of this integration was to create a preference for dividends over capital gains at certain income levels: Robert D. Brown, "Last Gun-Fight at the Surplus-Stripping Corral," *Report of Proceedings of the Thirtieth Tax Conference*, 1978 Conference Report (Toronto: Canadian Tax Foundation, 1980), 590-626. As will be seen, this is a recurring issue.

6 See, for example, William R. Lawlor, "Surplus Stripping and Other Planning Opportunities with the New $500,000 Capital Gains Exemption," (1986), vol. 34, no. 1 *Canadian Tax Journal*, 49-110.

7 Michael J. O'Keefe, "Surplus Stripping After Tax Reform," *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 17:1-20.

8 Stikeman and Couzin, *supra* note 1.

9 *Gwartz v. R.*, 2013 D.T.C. 1122 (T.C.C.); *Evans v. R.,*2005 D.T.C. 1762 (T.C.C.).

10 *Collins & Aikman Products Co. Ltd. v. R.*, 2009 D.T.C. 1179 (T.C.C.), affirmed 2010 D.T.C. 5164 (F.C.A.).

11 *Copthorne Holdings Ltd. v. R.*, [2011] 3 S.C.R. 721 (S.C.C.) at paras. 44-47, affirming 2009 D.T.C. 5101 (F.C.A.), affirming 2007 D.T.C. 1230 (T.C.C.).

12 *Brouillette c. R.*, 2005 D.T.C. 1004 (T.C.C.).

13 Lest it be thought that the authors are making an absurd argument, the Carter Commission, *supra* note 4 at Chapter 19, noted that shareholders of public corporations could realize on their share of undistributed retained earnings by selling their shares, thus engaging in a form of "surplus stripping" as defined. It is obviously unreasonable to suggest that the GAAR should apply to deny that tax benefit or the tax benefit arising on a sale of shares of a private corporation with undistributed retained earnings, but the need to resort to a judgment about "reasonability" suggests strongly that there is no legislative scheme that could be as broad as the CRA has argued.

14 After taking into account the general rate reduction in subsection 123.4 and the provincial abatement in subsection 124(1) .

15 Stikeman and Couzin, *supra* note 1.

16 For additional comments on the design of this system and policy alternatives, see Thomas E. McDonnell, "The Taxation of Investment Income of Private Corporations and Personal Services Business Income," *Report of Proceedings of the Thirty-Fourth Tax Conference*, 1982 Conference Report (Toronto: Canadian Tax Foundation, 1983), 103-147.

17 Ken McKenzie and Charles Taylor, "Business Income Taxation," *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012) at 7:6.

18 *Ibid.*, at 7:46-7:49.

19 *Ibid.*, at 7:12-7:14. See also Stikeman and Couzin, *supra* note .

20 Carter, *supra* note 3, Chapter 19.

21 See, for example, Hans Fehr, Sabine Jokisch, Ashwin Kambhampati and Laurence J. Lotlikoff, "Simulating the Elimination of the U.S. Corporate Income Tax," (2013), *NBER Working Papers*, no. 19757.

22 Carter, *supra* note 4, Chapter 19.

23 Johansson, Å. et al. (2008), "Taxation and Economic Growth", *OECD Economics Department Working Papers*, No. 620, OECD Publishing.

24 Duanjie Chen and Jack Mintz, "Small Business Taxation: Revamping Incentives to Encourage Growth," (2011), vol. 4, no. 7, *School of Public Policy Research Papers* at 3-4.

25 Canada, *Tax Expenditures and Evaluations 2013*, (Ottawa: Department of Finance, 2014) at 22.

26 For example, the Alberta small business deduction represents a tax expenditure of approximately $1,100,000,000 per year: Alberta, "Tax Plan," *Fiscal Plan 2014-17*, (Edmonton: Treasury Board and Finance, 2014) at 123.

27 Chen and Mintz, *supra* note 25 at 20-21; Canada, *Report of the Technical Committee on Business Taxation*, (Ottawa: Department of Finance, 1997), Chapter 5.

28 Paragraph 21(o) of the *Alberta Corporate Tax Act*, R.S.A. 2000, c. A-15 and section 4 and subsection 6(1) of the *Alberta Personal Income Tax Act*, R.S.A. 2000, c. A-30.

29 Section 21 of the *Alberta Personal Income Tax Act*, R.S.A. 2000, c. A-30.

30 *Descarries c. R.*, 2014 CCI 75.

31 For additional discussion on these points, see James R. Wilson, "The Structural Impact of the Capital Gains Deduction on the Canadian Tax System," (1995), vol. XXI:Suppl., *Canadian Public Policy*, 206-224.

32 *Tax Expenditures*, *supra* note 25. The estimated tax expenditures for 2012 were $605,000,000 for the small business corporation shares and $385,000,000 for farm and fishing property.

33 For example, the capital gains deduction represents a tax expenditure of approximately $72,000,000 per year in Alberta: *Fiscal Plan*, *supra* note 26.

34 1985 Budget Supplementary Information to section 110.6 .

35 Ontario Fair Tax Commission, *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto: University of Toronto Press, 1993) at 337-51, cited in Wilson, *supra* note 32.

36 Jack M. Mintz, "Reforming the Tax Cut Agenda," (2000), vol. 48, no. 3 *Canadian Tax Journal*, 689-709.

37 James B. Davies, "Distributional Effects of the Lifetime Capital Gains Exemption: Single vs. Multi-Year Analysis," (1995), vol. XXI:Suppl., *Canadian Public Policy*, 159-173.

38 Jack Mintz and Stephen R. Richardson, "The Lifetime Capital Gains Exemption: An Evaluation," (1995), vol. XXI:Suppl., *Canadian Public Policy*, 1-12.

39 Vijay M. Jog and Huntley Schaller, "Retirement Income and the Lifetime Capital Gains Exemption: The Case of Qualified Farm Property and Small Business Corporation Shares," (1995), vol. XII:Suppl., *Canadian Public Policy*, 136-158.

40 *Ibid*.

41 We suggest that the "multiplication" of the QSBC capital gains deduction is a plausible explanation for why the sample group of capital gains deduction claimants skews relatively young.

42 Stikeman and Couzin, *supra* note 1. As neither author was alive prior to 1969 or practicing law prior to 1994, this discussion relies heavily on Stikeman and Couzin's recounting of the legislative history.

43 The only cases we are aware of in which either section 138A of the 1948 *Income Tax Act* or subsection 247(1) was relied on by the Minister are *Champagne v. M.N.R.*, 77 D.T.C. 1698 (T.R.B.) and *Giguere v. M.N.R.*, 72 D.T.C. 1392 (T.R.B.). The former case was decided on procedural grounds, so the jurisprudence is essentially limited to the latter case.

44 *MacDonald v. R.*, 2012 D.T.C. 1145 (T.C.C.) at paras. 67-68, reversed 2013 D.T.C. 5091 (F.C.A.).

45 *Merritt v. M.N.R.*, [1940-41] C.T.C. 226 (Can. Ex. Ct.), reversed [1942] S.C.R. 269 (S.C.C.).

46 *MacDonald*, *supra* note 44 (F.C.A.) at para. 17.

47 *Canadian Marconi Co. v. R.*, [1986] 2 S.C.R. 522 (S.C.C.) at para. 10, reversing 84 D.T.C. 6267 (F.C.A.), reversing 82 D.T.C. 6236 (Fed. T.D.).

48 *Ibid*., para. 12.

49 See Document 2012-0445341C6 dated May 29, 2012.

50 *David v. R.*, 75 D.T.C. 5136 (Fed. T.D.) at para. 21.

51 *Copthorne Holdings Ltd. v. R.*, *supra*, note 11 at para. 47 of the reasons for judgment of the Supreme Court of Canada.

52 This was the case in *MacDonald*, *supra* note 44 (T.C.C.) at para. 85.

53 *MacDonald*, *supra* note 44 (F.C.A.) at para. 28

54 *Merritt*, *supra* note 45 at para. 7.

55 *Kennedy v. R.*, 72 D.T.C. 6357 (Fed. T.D.) at para. 43, affirmed on this point 73 D.T.C. 5359 (F.C.A.).

56 This list of conditions is appropriated from *Côté-Létourneau c. R.*, 2007 D.T.C. 768 (T.C.C.) at para. 28.

57 The term "connected" includes not only a reference to subsection 186(4), but, by necessity, a reference to subsection 184(2) as well: *Olsen v. R.*, 2002 D.T.C. 6770 (F.C.A.) at paras. 10-11, reversing 2000 D.T.C. 2121 (T.C.C.).

58 Paragraph 84.1(2)(a).

59 Paragraph 84.1(2)(a.1).

60 Paragraph 84.1(2)(b).

61 Paragraph 84.1(2)(d).

62 Paragraph 84.1(2.2)(b).

63 Paragraph 84.1(2.2)(a).

64 Paragraphs 84.1(2.2)(c) and (d).

65 For a case that may be an exception to this rule, see *Fiducie Famille Gauthier c. R.*, 2011 D.T.C. 1244 (T.C.C.), affirmed 2012 D.T.C. 5070 (F.C.A.), which concerned the value of non-share consideration received from the purchaser corporation. This does not, however, involve the application of a bright-line test.

66 See, for example, *Emory v. R.*, 2010 D.T.C. 1074 (T.C.C.).

67 See, for example, *Côté-Létourneau*, *supra* note 57; *Brouillette c. R.*, *supra*, note ; *McMullen v. R.*, 2007 D.T.C. 286 (T.C.C.); *Hickman v. R.*, 2000 D.T.C. 2584 (T.C.C.); *Campbell v. R.*, 99 D.T.C. 1073 (T.C.C.); *McNichol v. R.*, 97 D.T.C. 111 (T.C.C.); *Lauzier v. R.*, [1996] 3 C.T.C. 2440 (T.C.C.).

68 *Remai Estate v. R.*, 2009 D.T.C. 5188 (F.C.A.) at para. 32-46, affirming 2008 D.T.C. 4567 (T.C.C.). See also *Peter Cundill & Associates Ltd. v. R.*, 91 D.T.C. 5085 (Fed. T.D.) at paras. 28-33, affirmed 91 D.T.C. 5543 (F.C.A.) and *McLarty v. R.*, [2008] 2 S.C.R. 79 (S.C.C.) at para. 62, reversing 2006 D.T.C. 6340 (F.C.A.), reversing 2005 D.T.C. 217 (T.C.C.).

69 *Petro Canada Ltd. v. R.*, 2004 D.T.C. 6329 (F.C.A.) at para. 55, reversing 2003 D.T.C. 94 (T.C.C.).

70 Paragraph 212.1(3)(e). The term "majority-interest partner" is defined in subsection 248(1).

71 *Placements Serco Ltée v. R.*, 87 D.T.C. 5425 (F.C.A.) at para. 5, affirming 84 D.T.C. 6098 (Fed. T.D.).

72 Subparagraph 212.1(3)(b)(iv) .

73 Paragraph 212.1(3)(f) .

74 As in *RMM Canadian Enterprises Inc. v. R.*, 97 D.T.C. 302 (T.C.C.) at paras. 32-39.

75 *Dairy Queen Canada, Inc. v. Canada*, 95 D.T.C. 634 (T.C.C.).

76 See Meredith and Fehr, *supra*, note 1 for a very good recent summary of the surplus stripping jurisprudence.

77 Cases that can be classified as "accommodation" transactions include *M.N.R. v. Merritt*, *supra*, note 45; *Smythe v. M.N.R.*, 69 D.T.C. 5361 (S.C.C.); *David v. R.,*75 D.T.C. 5136 (F.C.T.D.); *Lauzier v. R., supra*, note 67; *McNichol v. R.*, *supra*, note 67; *RMM Enterprises Inc. v. R.*, *supra*, note 74; *Côté-Létourneau c. R.*, *supra*, note 56; *McMullen v. R.*, *supra*, note 67; and *Tremblay v. R.,*2009 D.T.C. 1104 (T.C.C.); affirmed at 2010 D.T.C. 5079 (F.C.A.).The case of *Brouillette v. R.*, *supra*, note was argued by the Crown as a surplus stripping case, but should not be considered part of the surplus stripping canon given the Tax Court's finding that the purchasers intended to (and did) acquire the corporation as a going concern and not as part of a strategy to monetize the share vendor's capital gains deduction. *Brouillette*is better characterized as a section 84.1 factual arm's length case.

78 As in *Smythe*, *supra*, note 77, where the corporation that was stripped was left holding worthless preferred shares that had been issued by the two accommodator corporations that were involved in the transactions. The economic results of the transactions in *Smythe* are summarized at paragraph 149 of the reasons for judgment of the Exchequer Court of Canada, reported at 67 D.T.C. 5334.

79 *Supra*, note 77.

80 *Tremblay* was not really a surplus stripping case. The shareholders' object in *Tremblay* was not to avoid dividend treatment on a corporate distribution, but to convert an investment in private corporation shares into an investment in public corporation shares prior to emigrating from Canada. This improved the liquidity of their investment, as a subsequent sale of the shares would not be subject to section 116 withholding: see Andrew Majawa and Michelle Moriartey, "Current Cases," 2010 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2010), 2:1-27 at 2:16.

81 Subsection 84(2) was not argued in*Côté-Létourneau, supra*, note and *Lauzier*, *supra*, note , which were assessed solely based on subsection 84.1.

82 *Supra*, note 67.

83 *Supra*, note 67.

84 *Supra*, note 77.

85 See *McNichol, supra*, note 67 at paragraph 14.

86 *MacDonald v. R., supra*, note 44.

87 *Ibid.,*at paragraphs 50-62 of the Tax Court of Canada reasons for judgment.

88 *Ibid.,*at paragraphs 25 through 29 of the Federal Court of Appeal reasons for judgment.

89 *RMM Enterprises*, *supra*, note 74.

90 See Meredith and Fehr, *supra*, note 1 at 14: 9-10.

91 *McNichol, supra*, note 67 at paragraph 13.

92 The Federal Court of Appeal in *MacDonald* distinguished *McNichol* rather than expressly overruling it based on certain different facts (a daylight loan was used by the accommodator in *McNichol*, whereas in *MacDonald*i it was possible to directly trace the corporate funds into the hands of the original shareholder). Nevertheless, the express endorsement of *RMM Enterprises* by the Federal Court of Appeal on another point of law in which *RMM Enterprises* stood in direct opposition to *McNichol* suggests that *RMM Enterprises* likely would also be followed if the tracing issue were brought directly before the Federal Court of Appeal.

93 *McMullen, supra*, note 67.

94 *Ibid.*, at paragraph 20.

95 See Steve Suarez and Firoz Ahmed, "Public Company Non-Butterfly Spinouts," Report of Proceedings of Fifty-Fifth Tax Conference, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 32:1-49, at 32:23, in which the authors

level this same criticism at the Tax Court of Canada's application of the "reorganization" concept in *Geransky v. R.*, 2001 D.T.C. 243 (T.C.C.).

96 *McMullen*, *supra*, note 67 at paragraph 21.

97 *Tremblay*, *supra*, note 77.

98 See Majawa and Moriartey, *supra*, note 80.

99 See *Tremblay*, *supra,*note 77 at paragraph 48 of the Tax Court of Canada's reasons for judgment.

100 *Ibid.,* at paragraphs 38-41 of the Federal Court of Appeal's reasons for judgment.

101 *Ibid.,*at paragraphs 47-52 of the Federal Court of Appeal's reasons for judgment.

102 This appears to have been incorrect, and the taxpayers argued that the shares of 8855 would have been taxable Canadian property and hence not subject to a deemed disposition under section 128.1 : see paragraph 43 of the reasons for judgment of the Federal Court of Appeal in *Tremblay*, *supra*, note 77.

103 *Ibid.,* at paragraph 15 of the Tax Court of Canada decision and paragraph 43 of the Federal Court of Appeal decision.

104 *Supra,*note 67.

105 *Supra* note 74.

106 In *RMM Enterprises*, a small percentage of the corporation's assets consisted of equipment leases that were acquired for cash by the share vendor about two months after the share sale closed pursuant to a guarantee given by the share vendor to the accommodator.

107 *McNichol, supra,*note 67 at paragraph 17.

108 *Ibid*., at paragraph 17.

109 *RMM Enterprises, supra*, note 74 at paragraph 39.

110 Tom Stack, CA, "Arm's Length as a Question of Fact," Report of Proceedings of Forty-Ninth Tax Conference, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 16:1-15 at 16:14-15.

111 *Windsor Plastic Products Ltd. v. R.,*86 DTC 6171 (F.C.T.D.).

112 *Ibid.,* at paragraph 21.

113 *Supra,*note 12.

114 *Supra,*note 67.

115 *Supra*, note 67.

116 *Ibid.,* at paragraph 14.

117 *Supra*, note 56.

118 *Ibid.*, at paragraphs 63-64.

119 *Supra*, note 67.

120 *Supra,*note 74.

121 *Supra*, note 12.

122 *Supra*, note 67.

123 *Canada Trustco Mortgage Co. v. R.,*2003 DTC 587 (S.C.C.).

124 *McNichol, supra*, note 67 at paragraph 25.

125 *Ibid.,*at paragraphs 24-25.

126 *RMM Enterprises, supra*, note 74 at paragraph 53.

127 *Evans v. R., supra*, note 9.

128 *Ibid.,*at paragraph 33.

129 *Ibid.,*at paragraph 33.

130 *Ibid.,*at paragraph 34.

131 *Ibid.,*at paragraph 30.

132 See *McMullen*, *supra*, note at paragraph 56; *Collins & Aikman, supra*, note at paragraphs 60-62 and 76-79 of the Tax Court of Canada decision and paragraph 1 of the Federal Court of Appeal decision in which the Court states its general approval of the Tax Court of Canada reasons for judgment; *Copthorne Holdings, supra,*note at paragraph 73 of the Tax Court of Canada decision; *MacDonald, supra*, note at paragraph 132 of the Tax Court of Canada Decision; *Gwartz*, *supra,*note 44 at paragraphs 29-50.

133 *Ibid.,*at paragraph 51.

134 *Ibid.,*at paragraph 54.

135 *Ibid.*, at paragraph 55.

136 *Supra*, note 12.

137 *Ibid*., at paragraph 50.

138 *Ibid.,*at paragraph 55.

139 This description of the pipeline transaction comes from Chris Falk and Stefanie Morand, "Current Issues Forum: Pipeline Planning; Subsection 164(6) Circularity Issue; Eligible Dividend Designations," *2012 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2012), 1B:1-26 at 1:4-5, which was published as a follow-up to Chris Falk and Stefanie Morand, "Current Issues Forum: Pipeline Planning; Section 159 Clearance Certificates; Charitable Sector; and Non-Profit Organizations," 2011 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2011), 1B:1-61. The two papers contain a thorough discussion of the technical issues and CRA administrative pronouncements related to pipeline transactions, along with practical planning tips for avoiding subsection 84(2) .

140 This type of pipeline transaction requires two steps. First an "internal" subsection 85(1) share exchange must be implemented in which existing shares of the original corporation are exchanged for new shares of that corporation, subject to a joint election in which the shareholder elects to realize a capital gain in the desired amount. The new shares can then be transferred to the pipeline corporation in exchange for a note or high PUC/high ACB shares without triggering a deemed dividend under section 84.1 .

141 In a straightforward pipeline transaction that does not involve an aggressive attempt to cash out capital gains deductions or V-Day increment, section 84.1 is avoided by ensuring that the value of the boot or the PUC of the shares of the new corporation received by the share vendor does not exceed the "hard" ACB of the shares of the original corporation.

142 *Supra,*note 44.

143 JS could transfer the PC shares to 601 in exchange for a promissory note without triggering a deemed dividend under section 84.1 because he had "hard ACB" of $525,608.

144 A final dividend of $25,068 was paid about two months after the transactions were implemented.

145 The Federal Court of Appeal did not discuss the Crown's GAAR arguments after finding that subsection 84(2) applied.

146 *Circa* note 86.

147 See, for example, CRA Document Nos. 2002-0154223, dated November 13, 2002, and 2005-0142111R3, dated November 2, 2005.

148 *MacDonald*, *supra*, note 44 at paragraph 80 of the Tax Court of Canada decision.

149 *Supra*, note 30.

150 *Ibid.,* at paragraph 32.

151 *Ibid.,* at paragraph 30.

152 *Ibid.*, at paragraphs 19, 20 and 28.

153 *Ibid.,* at paragraphs 28 and 33.

154 *Supra,* note 44. The Federal Court of Appeal in *MacDonald* did not consider the GAAR after reaching the conclusion that

subsection 84(2) applied.

155 *Supra,* note 10.

156 *MacDonald*, *supra*, note 44 at paragraph 121 of the Tax Court of Canada decision.

157 *Ibid.,*at paragraph 132 of the Tax Court of Canada decision.

158 *Collins & Aikman*, *supra*, note 10 at paragraphs 59-62 of the Tax Court of Canada decision.

159 *Ibid.,* at paragraphs 73-79 of the Tax Court of Canada decision.

160 *Ibid.,* at paragraph 1 of the Federal Court of Appeal decision.

161 *Nadeau v. R.,*99 D.T.C. 324 (T.C.C.).

162 *Desmarais v. R.*, 2006 D.T.C. 2376 (T.C.C.).

163 *Ibid.,* at paragraph 38.

164 *Supra*, note 30.

165 *Ibid.,* at paragraphs 57-59.

166 *Geransky v. R.*, 2001 D.T.C. 243 (T.C.C.), Crown's appeal to the Federal Court of Appeal discontinued.

167 Dave Rickards, "Hybrid Assets Share Planning when Selling Private Enterprises," *2013 British Columbia Tax Conference*, (Toronto: Canadian Tax Foundation, 2013), 8: 1-24; Mark Jadd and Eoin Brady, "Structuring the Purchase and Sale of a Business: Some Tips and Traps," *2011 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 2011), 11: 1-33.

168 *Geransky*, *supra* note 168 at paras. 12 & 13.

169 Technical Interpretation 2002-0156695 dated October 11, 2002.

170 See, for example, CRA Document No. 2011-0403031R3, January 18, 2012(supplemented by CRA Document No. 2011-0417741R3).

171 *Supra*, note 139 at 1B:18.

172 *Circa* note 149.

173 *Supra*, note 10.

174 *Supra*, note 55

175 The term "specified employee" is defined in subsection 248(1) as an employee who deals at arm's length with the corporation and who is not a "specified shareholder" of the corporation.

176 Mickey Sarazin, "The Income Tax Rulings Directorate and Its Interaction with Practitioners," *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 5:1-17.

177 See Durand, *supra* note 1.

178 Paul Hickey, "CRA's GAAR Update" (2013) vol. 21, no. 1 Canadian Tax Highlights, 3-4.

179 Discussed above *circa* note 136.

180 Discussed above *circa* note 133.

181 *Supra*, note , discussed above *circa* note 127.

182 See the discussion above *circa* note 138.

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