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The Permissibility of Surplus Stripping: A Brief History and Recent Developments

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PRÉCIS

Le « dépouillement des surplus » vise à structurer les paiements reçus par un particulier d'une société comme des gains en capital plutôt que comme des dividendes, afin que les paiements soient imposés à un taux plus faible. Alors que les tribunaux canadiens ont généralement jugé qu'il n'y avait pas de mécanisme anti-dépouillement des surplus dans la Loi de l'impôt sur le revenu, dans des décisions récentes, la Cour canadienne de l'impôt et la Cour d'appel fédérale se sont prononcées contre des contribuables qui avaient effectué des opérations de dépouillement des surplus. Le présent article examine dans quelle mesure le dépouillement des surplus reste permis par la Loi et se penche, en particulier, sur l'application du paragraphe 84(2), de l'article 245 (la règle générale anti-évitement [RGAE]), et des dispositions anti-dépouillement des surplus aux articles 84.1 et 212.1. Dans leur évaluation de la possibilité d'avoir recours aux opérations de dépouillement des surplus, les auteurs passent brièvement en revue le contexte législatif pertinent et cernent divers thèmes qui ont émergé de la jurisprudence sur la RGAE et le paragraphe 84(2). Les auteurs concluent que, nonobstant les récentes décisions judiciaires, certaines opérations de dépouillement des surplus devraient rester permises.

ABSTRACT

"Surplus stripping" seeks to structure payments received by an individual from a corporation as capital gains rather than dividends, so that the payments are taxed at a lower rate. While Canada's courts have typically held that there is no anti-surplus-stripping scheme in the Income Tax Act, recent decisions of the Tax Court of Canada and the Federal Court of Appeal have found against taxpayers that have engaged in surplus-stripping transactions. This article considers the extent to which surplus strips remain permissible under the Act and, in particular, considers the application of subsection 84(2), section 245 (the general anti-avoidance rule [GAAR]), and the specific anti-surplus-stripping provisions in sections 84.1 and 212.1. In assessing the permissibility of surplus-stripping transactions, the authors briefly review the relevant legislative history and identify various themes that have emerged from the jurisprudence

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on GAAR and subsection 84(2). The authors conclude that, notwithstanding recent court decisions, certain surplus-stripping transactions should remain permissible.

KEYWORDS: SURPLUS STRIPPING ■ HISTORY ■ ANTI-AVOIDANCE ■ GAAR ■ STATUTORY INTERPRETATION ■ JURISPRUDENCE

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INTRODUCTION

"Surplus stripping" is a tax-planning strategy that involves the structuring of payments received by an individual from a corporation as capital gains rather than dividends, so that the payments are taxed at a lower rate. This article considers the extent to which surplus-stripping transactions are permissible under the Income Tax Act (Canada)[1] in the context of subsection 84(2), the general anti-avoidance rule (GAAR) in section 245, and the specific anti-surplus-stripping provisions in sections 84.1 and 212.1. In particular, we review the relevant legislative history and identify a number of themes that have emerged from the jurisprudence addressing the application of GAAR and subsection 84(2).[2] We also review the position of the

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

2 There are many articles that have previously considered the application of GAAR and subsection 84(2) jurisprudence to surplus stripping. Some of the more recent articles include Alexander Demner and Kyle B. Lamothe, "The Future of Surplus Stripping," in *2019 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2019), 4:1-99; Erin Swint, "Optimizing Extractions from Private Corporations," in *2018 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2018), 13:1-62; David Baxter, Brandon Wiener, and Alexander

Canada Revenue Agency (CRA) on surplus stripping. We conclude that, notwithstanding recent court decisions, certain surplus-stripping transactions are still, and should remain, permissible.

LEGISLATIVE OVERVIEW

Although the history of surplus stripping in Canadian tax legislation stretches as far back as the 1920s,[3] our analysis begins with the modern provisions of section 84.1, subsection 84(2), sections 212.1 and 212.3, and section 245.

Surplus Stripping for Canadian Residents

Subsection 84.1(1) was added in 1976 in respect of payments made after November 18, 1974.[4] The stated purpose of the provision at the time it was introduced was "to prevent a resident individual from avoiding tax on surplus . . . by means of a non-arm's length sale of shares . . . of one corporation to another."[5]

The origin of subsection 84.1(1) can be traced back to the introduction of section 14 of the Income War Tax Act,[6] which disallowed the conversion of a dividend into capital gains through the use of a second corporation acting as the first corporation's agent. In 1945, the Ives commission described the purpose of section 14 of the Income War Tax Act as follows:

> Were it not for this section, a person owning shares in Company A could cause to be incorporated Company B, and sell the shares to Company B at a price calculated by including the entire undistributed income of Company A. Company A could then declare a dividend equal to its entire undistributed income which would be tax free to

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Demner, "Surplus Stripping—What's Acceptable, What's Not, and What Should Be?" in *2014 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2014), 12:1-44; H. Michael Dolson and Jon D. Gilbert, "Accessing Surplus: What Works, What Doesn't, What's Left," in *2014 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2014), 9:1-57; Mark Meredith and Jacqueline Fehr, "Surplus Stripping: In the Eye of the Beholder," in *2013 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2013), 14:1-29; Ron Durand and Lindsay Gwyer, "Surplus Stripping and Domestic Private Corporations," in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 13:1-20; and Monica Biringer, "Surplus Stripping After Copthorne: Non-Resident Corporations," in the 2012 Conference Report, supra, 14:1-2.

3 The first provision to address surplus stripping was section 14 of the Income War Tax Act, 1917, SC 1917, c. 28. In the subsequent decades, various provisions attempting to address surplus stripping have been introduced and repealed. For a more detailed history of surplus stripping prior to 1995, see H. Heward Stikeman and Robert Couzin, "Surplus Stripping" (1995) 43:5 *Canadian Tax Journal* 1844-60.

4 Subsection 84.1(1) was added by SC 1974-75-76, c. 26, section 47(1).

5 Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, March 31, 1977.

6 Supra note 3.

> Company B under section 4(1)(n); Company B could use the money in part payment of the purchase price of the shares; and the original owner of the shares would thereby obtain free of tax, his proportion of the undistributed income of the company.[7]

Section 14 was repealed, along with many other specific anti-surplus-stripping rules that had been enacted in the 1920s, with the introduction of the 1948 Income Tax Act[8] and the adoption of the "designated surplus" concept. The designated surplus concept was an attempt to stop individuals from converting taxable dividends into tax-free capital gains by selling a corporation with accumulated retained earnings to a non-arm's-length company. The designated surplus rules were later repealed and were replaced with section 84.1.[9]

Current subsection 84.1(1) applies in respect of a non-arm's-length transfer of shares of a corporation resident in Canada ("the subject corporation") by an individual resident in Canada ("the transferor") to another corporation with which the transferor does not deal at arm's length ("the purchaser corporation") where, immediately after the transfer, the purchaser corporation holds more than 10 percent of the share capital of the subject corporation.[10] The application of subsection 84.1(1) results in a reduction of the paid-up capital (PUC) of the shares of the purchaser corporation (colloquially known as a "PUC grind"), such that the PUC is generally limited to the greater of (1) the PUC of the shares of the subject corporation ("the subject shares"), and (2) the adjusted cost base (ACB) of the subject shares to the transferor. If the transferor receives non-share consideration on the transfer, such as a promissory note, he or she will be deemed to have received a dividend from the purchaser corporation to the extent that the amount of such non-share consideration exceeds the greater of the PUC and the ACB to the transferor of the subject shares immediately before the disposition. To avoid double-counting, section 84.1 ensures that the amount of the deemed dividend is reduced by the amount of the PUC grind.

The Supreme Court of Canada noted in *Copthorne Holdings Ltd. v. Canada* that one purpose of the PUC grind in section 84.1 is to prevent the preservation of PUC where it would not achieve Parliament's purpose of "allowing only for a return of tax-paid investment without inclusion in income."[11]

Two amounts are excluded from the transferor's ACB of the subject shares for the purposes of section 84.1. The effect of these exclusions is to increase the amount of

7 Canada, *Report of the Royal Commission on the Taxation of Annuities and Family Corporations* (Ottawa: King's Printer, 1945) ("the Ives commission"), at 55.

8 SC 1948, c. 52.

9 For a more detailed history of these legislative developments, see Dolson and Gilbert, supra note 2.

10 More specifically, subsection 84.1(1) requires that the purchaser and the subject corporation be "connected" within the meaning of that term set out in subsection 186(4).

11 *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, at paragraph 96.

the PUC grind or deemed dividend under section 84.1, and thus reduce the amount that the transferor can withdraw as a tax-free return. First, value accumulated in the subject shares prior to 1972 is excluded from the transferor's ACB for the purposes of section 84.1. This exclusion recognizes the fact that capital gains were not subject to tax prior to 1972. Therefore, the crystallization of value accumulated before that time in respect of the ACB of those shares should not be available to strip the corporation of its assets. Second, section 84.1 was amended in 1985 to address the introduction of the lifetime capital gains exemption in section 110.6. The amendment provides that, for the purposes of section 84.1, the transferor's ACB is reduced to the extent that the lifetime capital gains exemption has been claimed in respect of a capital gain on a prior disposition of the subject shares by either the taxpayer or a non-arm's-length individual. The ACB resulting from these transactions is colloquially known as a share's "soft" ACB, while a share's ACB attributable to any other transaction is known as the share's "hard" ACB.

Surplus Stripping for Non-Residents of Canada

Section 212.1 is the sister provision to section 84.1, applicable to non-resident transferors. Section 212.1 was introduced in 1977 to preclude a non-resident from avoiding tax on dividends by way of a non-arm's-length sale of shares of a Canadian-resident corporation to another Canadian-resident corporation. Like section 84.1, section 212.1 was introduced to replace the designated surplus rules, which had been deemed to be overly broad for interfering with bona fide acquisition and reorganization transactions. Section 212.1 may operate to grind the PUC of the purchaser corporation shares issued to a non-resident transferor and deem the transferor to have received a dividend, which would be subject to withholding tax, in circumstances similar to those described in respect of section 84.1.

There are two notable differences between section 84.1 and section 212.1. First, section 212.1 applies where the transferor is a corporation or an individual. Second, section 212.1 does not recognize the transferor's ACB, such that the PUC grind in respect of the class of shares of the purchaser corporation and the amount of the deemed dividend to the transferor are calculated only with reference to the PUC of the shares of the subject corporation. The rationale for this exclusion is that, absent section 212.1, a non-resident vendor could increase its ACB through a gain recognition transaction that would not be taxable in Canada and, in doing so, effectively convert dividends subject to Canadian withholding tax into capital gains not subject to Canadian tax.

There have been two notable recent amendments to section 212.1. Subsection 212.1(4) provides an exception to the cross-border anti-surplus-stripping rule in subsection 212.1(1). Generally, subsection 212.1(4) allows the unwinding of a sandwich structure, where a Canadian-resident corporation ("Can Parent") holds shares of a non-resident corporation ("NR Co"), which holds the shares of a Canadian-resident corporation ("Can Subco"). Where subsection 212.1(4) is engaged, subsection 212.1(1) will not apply to the sale of Can Subco by NR Co to Can Parent.

Subsection 212.1(4) was amended in 2016[12] to bar the application of the exception in subsection 212.1(4) where a non-resident (1) owns, directly or indirectly, shares of Can Parent and (2) does not deal at arm's length with Can Parent. The 2016 amendment was made to prevent non-resident corporations with Canadian subsidiaries from reorganizing their corporate structure to qualify for the subsection 212.1(4) exception. However, the amendment has been criticized on the ground that it discriminates between non-resident purchasers and resident purchasers in the context of bona fide acquisition transactions and related post-acquisition reorganizations, and is therefore arguably contrary to the original purpose behind section 212.1, which was simply to "distinguish a normal sale from a sale which is part of a contrived scheme."[13]

In 2018, section 212.1 was further amended to include "lookthrough" rules with respect to partnerships and trusts, to ensure that the original rule cannot be thwarted by involving such conduits.[14]

Foreign Affiliate Dumping

The foreign affiliate dumping rules ("the FAD rules") in section 212.3 were introduced in 2012.[15] These rules are extremely complex; therefore, this article provides only a brief overview of their application.

The FAD rules are generally designed to prevent a foreign corporation[16] (a "non-resident parent") from using a corporation resident in Canada (a "CRIC") as an intermediary to invest in a foreign affiliate (a "non-resident Subco").[17] One of the stated purposes of section 212.3 is to extend the "cross-border surplus stripping rule[s] to cover transactions involving foreign affiliates"[18]—for example, where a non-resident parent directly holds the shares of a non-resident Subco and transfers the shares to a CRIC. Where the acquisition of the shares of a non-resident Subco is

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12 The legislative change was made in response to the decision of the Federal Court of Appeal in *Univar*, infra note 73.

13 Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, "Federal Budget 2016: Proposed Amendment to Back-to-Back Rules and Section 212.1," submission to the Department of Finance, July 25, 2016, at 24. See the appendix to the joint committee's submission for a fuller history of section 212.1 and, in particular, subsection 212.1(4).

14 For further details on the section 212.1 lookthrough rules, see Demner and Lamothe, supra note 2, at 12-14.

15 Bill C-45, Jobs and Growth Act, 2012, SC 2012, c. 31; royal assent December 14, 2012.

16 The 2019 federal budget proposed to extend these rules to generally apply where the foreign parent is a trust or a group of non-resident persons dealing with each other at arm's length. Canada, Department of Finance, 2019 Budget, March 19, 2019.

17 Canada, Department of Finance, *Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, March 2012).

18 Ibid.

made with internal funds of the CRIC, the transaction can be a mechanism for a non-resident controlling shareholder (or shareholders) to extract earnings from a Canadian subsidiary free of Canadian dividend withholding tax.

The FAD rules are designed to prevent this cross-border surplus stripping by (1) deeming the CRIC to have paid a dividend subject to Canadian withholding tax to the extent of any non-share consideration paid to the non-resident parent by the CRIC and/or (2) causing a reduction in the PUC of the shares issued by the CRIC (which may result in a deemed dividend at some later date—for example, if the CRIC makes a return of capital).

Windups, Discontinuances, and Reorganizations

Subsection 84(2) applies

> [w]here 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.

Where subsection 84(2) applies, the corporation is deemed to have paid, and the shareholder is deemed to have received, a dividend to the extent that the fair market value (FMV) of the funds or property distributed exceeds the amount by which the PUC in respect of the affected class of shares of the corporation is reduced. Where the recipient shareholder is a non-resident, the deemed dividend arising on the application of subsection 84(2) is subject to part XIII non-resident withholding tax at a rate of 25 percent (subject to any applicable reduced treaty rate).

The history behind subsection 84(2) dates back to the Income War Tax Act, in which it existed in a relatively simple form as subsection 19(1). Subsection 19(1) of the Income War Tax Act was introduced to prevent the conversion of dividend income into capital gains by deeming any distribution of property on a windup, discontinuance, or reorganization of a business to be a dividend to the extent that the company had undistributed income on hand. In the 1948 Income Tax Act, the provision evolved to take the form of subsection 81(1), which contained most of the core elements present in subsection 84(2).[19]

The CRA has stated that it will seek to apply subsection 84(2) to surplus-stripping transactions that involve a windup, discontinuance, or reorganization of the business of a corporation.[20]

Other Anti-Avoidance Rules

Currently, GAAR (section 245) is the primary significant provision in the Act that may address surplus stripping when none of the specific provisions referred to

19 For further details about the history of subsection 84(2), see Dolson and Gilbert, supra note 2.

20 See, for example, CRA document no. 2007-0224151E5, August 13, 2007.

above apply. Prior to the introduction of GAAR, a number of anti-surplus-stripping rules were enacted and subsequently repealed. The most prominent of these provisions was former subsection 247(1), and its predecessor, section 138A, which was first introduced in 1963. The purpose behind former subsection 247(1) and its predecessor was to provide the minister with discretion to close loopholes in order to prevent surplus stripping in circumstances not already blocked by existing legislation, and to act as a deterrent to those who would otherwise attempt to avoid tax by implementing stripping-stripping schemes.[21] More specifically, former subsection 247(1) gave the minister discretion to recharacterize an amount received by an individual taxpayer as a deemed dividend where a transaction was structured to avoid section 84.1 or 212.1. The main target of the provision seemed to be situations in which the seller and the purchaser corporation did not deal at arm's length.[22] The provision was designed to prevent the extraction of corporate surplus as a capital gain in such situations. In response to longstanding criticism, subsection 247(1) was redrafted in 1985 to remove the element of ministerial discretion. However, throughout the lifetime of former subsection 247(1), there was very little litigation concerning the substance of the provision.[23]

GAAR was introduced with the 1987 tax reform in response to the Supreme Court of Canada's decision in *Stubart Investments Limited v. The Queen*.[24] This new provision was intended to limit what the court described as "the action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally-guided and equally specialized taxpayer reaction."[25]

Former subsection 247(1) was repealed in 1988 with the introduction of section 245, since it was believed that GAAR would be sufficient to quell any impermissible surplus-stripping activity. Since 1988, the CRA has assessed various transactions under GAAR on the basis that taxpayers intended to avoid section 84.1 or 212.1. The courts have grappled with the application of GAAR to these various surplus-stripping transactions and, specifically, the scheme of the Act that is allegedly being abused by such transactions.

Before turning to the jurisprudence, it is relevant to mention the Department of Finance's most recent legislative attempt to subdue surplus-stripping activity. On July 18, 2017, the department announced proposals to amend section 84.1 and to introduce new section 246.1, with the purported aim of "prevent[ing] the surplus income of a private corporation from being converted to a lower-taxed capital gain

21 C.W. Primeau, "Surplus Stripping: The Departmental View" (1974) 22:5 *Canadian Tax Journal* 421-29, at 422.

22 Ibid.

23 For a detailed history of surplus-stripping legislation, see Stikeman and Couzin, supra note 3.

24 *Stubart Investments Ltd. v. The Queen*, [1984] 1 SCR 536.

25 Ibid., at 581; cited in Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: Department of Finance, June 18, 1987), at 130.

and stripped from the corporation."[26] The proposed amendment to section 84.1 provided that, in computing the hard ACB of a share, the transferor's ACB would be reduced by the amount of any capital gain realized after 1984 in respect of a previous disposition by the transferor or by another individual not dealing at arm's length with the transferor. Generally, proposed section 246.1 would have applied in a non-arm's-length context and was intended to prevent the distribution of corporate surplus as a taxable dividend to a Canadian-resident individual where the individual would either pay no tax on the distribution or pay tax at the lower capital gains rate. The language of the new proposed section closely resembled that of former subsection 247(1).

In effect, the proposals acknowledged that GAAR does not prevent all surplus-stripping activities. The new measures were strongly criticized by the tax community as being overly broad and having unintended negative consequences for "legitimate commercial transactions."[27] The minister decided not to proceed with the proposals, leaving GAAR as the main provision in the Act to address surplus stripping, other than the technical provisions outlined above.[28]

REVIEW OF THE JURISPRUDENCE

The Application of GAAR: Canada Trustco

The Supreme Court of Canada in *Canada Trustco Mortgage Co. v. Canada*[29] stated that the application of GAAR, as set out in subsections 245(1) through (5), involves three steps.[30] First, it must be determined whether a tax benefit arose from the transaction or from a series of transactions that includes the transaction, in accordance with subsections 245(1) and (2). Second, it must be determined whether the transaction is an avoidance transaction, in that the transaction was not "arranged primarily for *bona fide* purposes other than to obtain the tax benefit," in accordance with subsection 245(3). Where the taxpayer has undertaken a series of transactions resulting in a tax benefit, as is often the case in a surplus-stripping transaction, the existence of a single avoidance transaction within the series is sufficient for this second condition to be met.[31] Third, it must be determined whether the avoidance

26 Canada, Department of Finance, *Tax Planning Using Private Corporations* (Ottawa: Department of Finance, July 18, 2017), at 15.

27 Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, "July 18, 2017: Part D of Taxation of Private Corporations—Converting Income into Capital Gains Proposals," submission to the Department of Finance, October 2, 2017, at 28.

28 Canada, Department of Finance, "Targeted Tax Fairness Measures Will Protect Small Business Owners Including Farmers and Fishers," *News Release*, October 19, 2017.

29 2005 SCC 54.

30 See ibid., at paragraph 17.

31 *Copthorne*, supra note 11, at paragraph 40.

transaction is abusive, in accordance with subsection 245(4). The taxpayer has the burden of showing that there was no tax benefit or avoidance transaction; the minister has the burden of showing that there was an abuse.[32]

In respect of the third step of the GAAR analysis, the Supreme Court stated that a two-part inquiry is required:

> The first step is to determine the object, spirit or purpose of the provisions of the *Income Tax Act* that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids. The second step is to examine the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue.[33]

The Supreme Court further noted that

> [t]he first part of the inquiry under s. 245(4) requires the court to look beyond the mere text of the provisions and undertake a contextual and purposive approach to interpretation in order to find meaning that harmonizes the wording, object, spirit and purpose of the provisions of the *Income Tax Act*. . . . In order to reveal and resolve any latent ambiguities in the meaning of the provisions of the *Income Tax Act*, the courts must undertake a unified textual, contextual and purposive approach to statutory interpretation.[34]

As will be seen below, a court's determination of the object, spirit, and purpose of the various anti-surplus-stripping rules in the Act is often the single most important step in the GAAR analysis.

The Courts' Position on the Existence of an Anti-Surplus-Stripping Scheme

Since the introduction of GAAR, the jurisprudence addressing surplus-stripping transactions can roughly be divided into three periods. The first period began in 1997 with the first cases involving the application of GAAR in the context of surplus stripping. The courts were quick to conclude that an anti-surplus-stripping scheme existed in the Act. In coming to this conclusion, the courts considered a number of factors, including the legislative history of the government's response to surplus stripping and, in particular, the repeal of former subsection 247(1) with the introduction of GAAR. The second period began in 2005, soon after the Supreme Court's decision in *Canada Trustco*, and ended in 2011 with the Supreme Court's decision in *Copthorne*. During this period, with few exceptions, the courts backtracked from their previous position that the Act contained an anti-surplus-stripping scheme.

32 *Canada Trustco*, supra note 29, at paragraphs 63-64.

33 Ibid., at paragraph 55.

34 Ibid., at paragraph 47. See also *Copthorne*, supra note 11, at paragraphs 69-70.

Also, in considering the object, spirit, and purpose of sections 212.1 and 84.1, the courts gave these provisions a narrow interpretation. The third and final period began in 2011, following the decision in *Copthorne*, which contains the Supreme Court's most recent pronouncement on GAAR. The court noted in *Copthorne* that (1) although there is no anti-surplus-stripping scheme in the Act, there is a comprehensive PUC scheme designed to limit artificial increases in PUC that would otherwise allow taxpayers to extract surplus tax-free; and (2) sections 84.1 and 212.1 form constituent parts of this PUC scheme.[35] Most recently, the lower courts, and the Federal Court of Appeal in particular, have used broad language in articulating the scope of the PUC scheme set out in *Copthorne*.

Cases involving the application of GAAR to transactions designed to avoid sections 84.1 and 212.1 generally focus on the object, spirit, and purpose of the scheme that is supported by these provisions and whether the avoidance transaction at issue abuses that scheme.

As discussed in greater detail below, the minister has generally sought to apply GAAR and subsection 84(2) simultaneously in situations where it is alleged that the taxpayer has engaged in impermissible surplus-stripping transactions.[36] Given that the jurisprudence addressing the application of subsection 84(2) in the context of surplus-stripping transactions has often considered that provision together with section 84.1 and GAAR, the analysis below will also consider these provisions collectively.

Surplus Stripping, Part One (1997-2005)

In 1997, the Tax Court of Canada issued judgments in two cases that concerned surplus strips. The first case, *McNichol et al. v. The Queen*,[37] involved the application of GAAR (in the alternative) to a transaction designed to avoid section 84.1; the second, *RMM Canadian Enterprises Inc. et al. v. The Queen*,[38] involved the application of GAAR to a transaction designed to avoid section 212.1. In both cases, the minister also sought to apply subsection 84(2) to deem the funds received to be a dividend.

In *McNichol*, four individual taxpayers were partners of a law firm that rented space from a building owned by their jointly owned holding company ("Bec"). The relationship between the partners had deteriorated such that the taxpayers had no

35 *Copthorne*, supra note 11, at paragraphs 92-96.

36 In *RMM Canadian Enterprises Inc. et al. v. The Queen*, 97 DTC 302, at 311 (TCC), the court noted, "If I am right in believing that sections 84 and 212 or, alternatively, section 212.1, by themselves result in taxing this surplus strip, recourse to section 245 is not only unnecessary but inappropriate." Accordingly, if the minister wishes to apply both subsection 84(2) (or section 84.1 or 212.1) and GAAR to a transaction, the minister should proceed with the assessment under subsection 84(2) as the primary assessing position and the assessment under GAAR as an alternative assessing position.

37 97 DTC 111 (TCC).

38 *RMM*, supra note 36.

further use for the building. Bec sold the building, its primary asset, for $600,000 and distributed half the gains to the appellants by way of a capital dividend. The remaining assets of Bec, valued at approximately $315,000, consisted almost exclusively of cash. Rather than distributing these remaining assets by way of a dividend, the taxpayers sought out a third-party purchaser to acquire all of the outstanding shares of Bec. The purchaser, Mr. Forestell, incorporated a wholly owned corporation, Beformac Holdings Limited ("Beformac"), which borrowed money from the Canadian Imperial Bank of Commerce (CIBC) against Bec's assets to purchase the shares of Bec from the appellants for $300,000. The taxpayers each claimed their respective lifetime capital gains exemptions on the sale. The transactions had the effect of transforming what would have otherwise been a taxable dividend on the windup of Bec into a tax-free capital gain.

The Tax Court rejected the minister's arguments that (1) subsection 84(2) applied to the transaction on the ground that the cash received by the taxpayers on the sale was originally from CIBC and not from Bec, and (2) section 84.1 applied to the transaction on the basis that the taxpayers and Mr. Forestell dealt, and negotiated the transaction, at arm's length. Instead, the court held that the transaction violated GAAR and, in particular, the anti-surplus-stripping scheme in the Act, which it described as a "legislative scheme to tax as income all distributions by a corporation to a shareholder."[39] In rendering its decision, the court further stated that the repeal of former subsection 247(1), a provision intended to prevent surplus stripping, could not be regarded as a basis for the conclusion that "the legislature intended to relax the strictures against surplus stripping."[40]

In *RMM*, a non-resident corporation ("EC") and a subsidiary of a publicly traded corporation ("IC") held all of the outstanding shares of a Canadian-resident corporation ("EL"). EL held all of the outstanding shares of another Canadian corporation ("ECL"), whose combined assets consisted of $3 million in cash, a $1.5 million entitlement to an income tax refund, and a portfolio of equipment leases. As an alternative to winding up EL and ECL, and thereby triggering a deemed dividend under subsection 84(2) that would be subject to part XIII non-resident withholding tax, the general counsel of IC approached a business associate about acquiring EL. This business associate along with two other individuals formed a Canadian corporation ("RMM") for the purpose of acquiring the shares of EL. RMM acquired the shares of EL for a purchase price approximately equal to the amount of cash and the refund entitlement. After the sale, EL was wound up into RMM, and ECL was amalgamated with RMM. The effect of the transactions was that EC realized a capital gain on the sale of the shares of EL, which was not subject to Canadian tax pursuant to the Canada-US tax treaty,[41] rather than a dividend subject to withholding tax on what would have been a windup of EL and ECL.

39 *McNichol*, supra note 37, at 121.

40 Ibid.

41 Infra note 64.

The Tax Court held that (1) subsection 84(2) applied to the transactions to deem the funds received to be a dividend, stating that "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"; and (2) section 212.1 applied to the transaction on the basis that RMM was under the de facto control of EC.[42] In the alternative, the court stated that GAAR would apply to deem the appropriate portion of the sale proceeds to be a dividend, and cited *McNichol* for the proposition that the Act contains an anti-surplus-stripping scheme.[43]

Surplus Stripping, Part Two (2005-2011)

Following the Supreme Court's decision in *Canada Trustco*, the lower courts began to reconsider their position that the Act contained an anti-surplus-stripping scheme and generally held that sections 84.1 and 212.1 should be given a narrow interpretation.

The first case rejecting the existence of an anti-surplus-stripping scheme was the 2005 decision of the Tax Court in *Evans v. The Queen*.[44] In *Evans*, the taxpayer owned a corporation ("117679"), which issued a stock dividend of non-voting shares to the taxpayer that were redeemable and retractable for an aggregate amount equal to $487,000. The taxpayer transferred these shares to a partnership of which his wife was the general partner, and in which his children held a 99 percent limited partnership interest, in consideration for a $487,000 interest-bearing promissory note. The taxpayer used his lifetime capital gains exemption to shelter the gain he realized in respect of the sale. Dividends were paid on the shares, and the shares were redeemed over a period of three years. These dividends and redemption proceeds were included in the income of the partners, on which they paid a nominal amount of tax. The amounts received by the partners were subsequently paid to the taxpayer in respect of the principal and interest owing on the note. In effect, the taxpayer converted a dividend payment from 117679 into a capital gain. The minister applied GAAR and recharacterized the proceeds received by the taxpayer pursuant to the transfer as a dividend.

The Tax Court reversed the minister's reassessment. In respect of the application of GAAR, the court stated that there is no "overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends."[45] The court also noted that the transactions did not lack economic

42 *RMM*, supra note 36, at 307 and 311.

43 Ibid., at 313.

44 2005 TCC 684.

45 Ibid., at paragraph 30.

substance in that there was "a genuine change in legal and economic relations [that] took place as the result of the transactions."[46]

In the following year, the Tax Court heard another surplus-stripping case, *Desmarais v. The Queen.*[47] In *Desmarais*, the taxpayer held 14.28 percent of the shares of a Canadian corporation ("Comerscom"), with a nominal ACB. The taxpayer incorporated a new wholly owned corporation ("6311") and transferred 9.76 percent of the shares of Comerscom to 6311 with an elected amount of $123,000. The taxpayer claimed his lifetime capital gains exemption in respect of the gain realized on the transfer. Section 84.1 did not apply to the transfer because 6311 did not hold more than 10 percent of the shares of Comerscom following the transfer, and therefore the two corporations were not "connected" within the meaning of that term in subsection 186(4). The taxpayer subsequently transferred shares that he held in another Canadian corporation ("Gestion") to 6311 on a tax-deferred rollover basis, and 6311 issued a separate class of shares to the taxpayer, thereby avoiding the averaging of the PUC of those shares with the PUC of the shares received on the earlier transfer. Gestion paid a dividend to 6311, which 6311 used to finance the redemption of its high PUC shares held by the taxpayer. As a result of these transactions, $123,000 was distributed to the taxpayer tax-free.

The Tax Court applied GAAR to deny the tax benefit achieved by the taxpayer as a result of the series of transactions. The court noted that, notwithstanding that 6311 and Comerscom were not connected after the transfer, the taxpayer indirectly retained more than 10 percent control of Comerscom and was therefore still able to exercise "substantial influence" over it following the transfer.[48] The decision in *Desmarais* supports the proposition that GAAR will be applied to ensure that section 84.1 is not avoided by circumventing the connected status test in subsection 186(4), notwithstanding technical compliance with the provision. In this case, the court did not reject the existence of an anti-surplus-stripping scheme in the Act and noted that the intention of section 84.1 is "to prevent stripping of the surpluses of an operating company."[49] However, in light of *Evans* and the subsequent jurisprudence discussed below, the applicability of the *Desmarais* decision can be restricted to its facts where a taxpayer has achieved technical compliance with section 84.1 by avoiding the "connected" rules in subsection 186(4).

The proposition put forth in *Evans* that the Act does not contain an anti-surplus-stripping scheme was reiterated by the Tax Court in two further cases, *McMullen v. The Queen*[50] and *Collins & Aikman Products Co. v. The Queen.*[51]

46 Ibid., at paragraph 35.

47 2006 TCC 44.

48 Ibid., at paragraph 34.

49 Ibid., at paragraph 32.

50 2007 TCC 16.

51 2009 TCC 299; aff'd 2010 FCA 251.

In *McMullen*, the Tax Court declined to apply GAAR in the context of an arm's-length surplus-stripping transaction. Mr. McMullen and his business partner, Mr. DeBruyn, were equal shareholders in a company ("DEL"), which operated a heating and air conditioning business at a loss. The partners decided to sever their business relationship by separating the corporation's two existing branches and each taking ownership of one branch. In order to effect the transaction, Mr. DeBruyn's wife incorporated 1149530 Ontario Inc. ("114") and Mr. McMullen incorporated Haven Home Comfort Inc. ("HHCI"). Mr. McMullen then sold his shares of DEL to 114 for $150,000, and claimed his lifetime capital gains exemption in respect of the gain realized on the sale. DEL obtained a loan and declared a dividend of $150,000 to the benefit of 114, which was not taxable because of the application of subsection 112(1). DEL issued a promissory note in satisfaction of the $150,000 dividend, and 114 then assigned the note to Mr. McMullen in satisfaction of the purchase price. Mr. McMullen subsequently transferred the note to HHCI, which acquired the Kingston branch of the corporation for FMV. DEL then used the proceeds to repay its loan.

The Tax Court held that section 84.1 did not apply since Mr. McMullen acted at arm's length with his business partner at the time that he sold his shares of DEL. The court further held that GAAR did not apply to recharacterize the transactions. In this respect, the court found that none of the transactions in the series was an avoidance transaction, since each transaction had been undertaken primarily for the bona fide non-tax purpose of terminating Mr. McMullen's business association with Mr. DeBruyn. Although this was sufficient to find in favour of the taxpayer, the court went on to deny the existence of an anti-surplus-stripping scheme in the Act. In doing so, it affirmed the holding in *Evans* that there is no "overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends."[52] The court therefore held that the transactions were not abusive.

In *Collins & Aikman*, the taxpayer, a corporation resident in the United States ("Products"), transferred shares of its non-Canadian subsidiary ("CAHL") to a newly incorporated Canadian-resident subsidiary ("Holdings") in exchange for a single common share of Holdings with PUC equal to the FMV of CAHL. CAHL subsequently amalgamated with two other Canadian corporations. The amalgamated entity ("Amalco") was a resident of Canada. Amalco paid dividends to Holdings, which distributed these amounts as a return of capital to Products. As a result of the PUC of Holdings, Products was able to receive these distributions from Holdings free of part XIII withholding tax.

The Tax Court described the reorganization as "a clear example of when it would be inappropriate to regard transactions as abusive tax avoidance."[53] It rejected the

52 *McMullen*, supra note 50, at paragraph 53, quoting *Evans*, supra note 44, at paragraph 30.

53 *Collins & Aikman*, supra note 51 (TCC), at paragraph 104.

existence of an anti-surplus-stripping scheme in the Act, stating that although the early cases, including *McNichol* and *RMM*, suggested the existence of such a scheme, subsequent cases have held to the contrary, including the Tax Court's decision in *Copthorne*, where the court held that "reliance on a general policy against surplus stripping is inappropriate to establish abusive tax avoidance."[54] In a brief judgment, the Federal Court of Appeal affirmed the Tax Court's decision in *Collins & Aikman*. It added that it found nothing about the transactions to be abusive, since the scheme of the Act should not be interpreted to bar a foreign corporation (Products) from dealing as it wished with the shares of a non-resident (CAHL).[55] In this vein, the Federal Court of Appeal stated, "We see no reason to conclude that the limited scope of [sections 84.1 and 212.1] was anything other than a deliberate policy choice by Parliament."[56]

The position of the lower courts that the Act does not contain an anti-surplus-stripping scheme was affirmed by the Supreme Court of Canada in its 2011 decision in *Copthorne*.[57] In *Copthorne*, the taxpayer undertook a series of transactions in which it reorganized a parent and a subsidiary corporation to become two sister corporations. The taxpayer then caused the sister corporations to be amalgamated, such that the PUC of the former subsidiary corporation was not eliminated on the amalgamation in accordance with subsection 87(3).

Although *Copthorne* did not involve the application of section 84.1 or 212.1, the Supreme Court commented on the scheme of these provisions. In this regard, the court held that the Act does not contain an anti-surplus-stripping scheme.[58] Rather, the court stated that the Act contains a PUC scheme. The court then proceeded to describe this PUC scheme and how various provisions, including sections 84.1 and 212.1, fit into the scheme. The court stated that the existence of PUC is a "recognition of the fact that the initial investment is made with tax-paid funds."[59] The court noted that sections 84.1 and 212.1 are provisions that grind PUC and that the purpose of these PUC grinds is to preserve the PUC scheme in the Act, which is inextricably tied to a corporation's stated capital account.[60] The court further noted that the PUC grinds enumerated in subsection 89(1) are intended "to prevent the preservation of PUC in instances where bare reliance on stated capital

54 Ibid., at paragraph 77, quoting *Copthorne Holdings Ltd. v. The Queen*, 2007 TCC 481, at paragraph 73, and also citing *McMullen*, supra note 50, at paragraph 56, where the court affirmed this proposition.

55 *Collins & Aikman*, supra note 51 (FCA), at paragraph 4.

56 Ibid. The transactions at issue in *Collins & Aikman* would now be subject to the FAD rules.

57 *Copthorne*, supra note 11.

58 See ibid., at paragraph 118, where the court stated that "[w]hat is not permissible is basing a finding of abuse on some broad statement of policy, such as anti-surplus stripping."

59 Ibid., at paragraph 93.

60 Ibid., at paragraph 95.

would not achieve *Parliament's intended tax purpose of allowing only for a return of tax-paid investment without inclusion in income*."[61] However, the court also stated that the existence of any scheme in the Act, including the PUC scheme, must address the "provisions at issue" and cannot be in relation to "a general policy unrelated to the scheme under consideration," such as "anti-surplus stripping."[62]

In sum, the Supreme Court's decision in *Copthorne* confirmed the jurisprudence that had been developing in the lower courts—namely, that the Act does not contain an anti-surplus-stripping scheme. The court's holding that the Act contains a PUC scheme represents an important development in the surplus-stripping jurisprudence, since the existence of such a scheme in the Act had not previously been posited.

Surplus Stripping, Part Three (2011-2020)

In the cases decided since *Copthorne*, the Tax Court and the Federal Court of Appeal have been particularly careful to accommodate the Supreme Court's confirmation that there is no anti-surplus-stripping scheme in the Act, while recognizing that there exists a PUC scheme. In this regard, although taxpayers will certainly welcome the Supreme Court's finding regarding the lack of an anti-surplus-stripping scheme in the Act, its finding that the Act contains a PUC scheme has resulted in several lower-court decisions since *Copthorne* that have been unfavourable for taxpayers. Moreover, as discussed in greater detail below, an expansive interpretation of subsection 84(2) by the Federal Court of Appeal has created considerable uncertainty for taxpayers who have undertaken some types of surplus-stripping transactions.

Soon after *Copthorne*, the courts again addressed the issue of surplus stripping in *MacDonald v. The Queen*.[63] In *MacDonald*, the taxpayer had planned to emigrate to the United States but faced a deemed disposition of the shares of his wholly owned corporation ("PC") on emigration pursuant to subsection 128.1(4). Although the taxpayer had unused capital losses available to offset the gain, he would not have been able to achieve a corresponding step-up in tax basis for US tax purposes.[64] To address this issue, the taxpayer transferred his PC shares to his brother-in-law ("JS") in exchange for a promissory note equal to the FMV of the shares. JS subsequently

61 Ibid., at paragraph 96 (emphasis added).

62 Ibid., at paragraph 118, citing the Supreme Court's decision in *Canada Trustco*, supra note 29, at paragraph 41.

63 2012 TCC 123; rev'd 2013 FCA 110.

64 Although article XIII(7) of the Canada-US tax treaty provides that an individual taxpayer emigrating from Canada is entitled to a step-up in tax basis for US tax purposes, this provision was not applicable for the years at issue in *MacDonald*. See the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US tax treaty").

transferred the shares to a holding corporation ("601") in exchange for a promissory note. PC declared a dividend, and 601 used the funds to repay the note to JS, who in turn used the funds to repay the note to the taxpayer. PC was subsequently wound up.

The Tax Court found that neither subsection 84(2) nor GAAR applied. In this regard, the court held that

> triggering capital gains to utilize capital losses is not discouraged by the *Act* in any way. Transfers to a corporation without a section 85 election can be used to realize capital gains as can transfers between spouses. There is nothing abusive about realizing capital gains for no other purpose than to utilize available net capital losses.[65]

The court further held that

> it is doubtful whether in an integrated corporate/shareholder tax system, a surplus strip *per se* can be said to abuse the spirit and object of the *Act* read as a whole.[66]

The Federal Court of Appeal reversed the Tax Court's decision and held that subsection 84(2) applied on the basis that the distribution occurred in the course of a windup. Accordingly, the court found it unnecessary to comment on the application of GAAR to the taxpayer's transactions. The court found support for its finding in respect of subsection 84(2) in the broad wording of the provision, which applies where funds of a corporation are distributed or otherwise appropriated in "any manner whatever" on the windup, discontinuance, or reorganization of the corporation's business. In this regard, the court cited *RMM* for the proposition that the phrase "in any manner whatever" constitutes "words of the widest import, and cover[s] a large variety of ways in which corporate funds can end up in a shareholder's hands."[67] The court further noted that subsection 84(2) applied in *MacDonald* since "each transaction . . . was entered into and completed in contemplation of each other [transaction],"[68] and the series of transactions resulted in the windup of PC. The Federal Court of Appeal's liberal interpretation of subsection 84(2) arguably creates significant uncertainty for taxpayers undertaking surplus-stripping transactions in the course of a windup, discontinuance, or reorganization of a corporation's business, if proper consideration is not given to avoidance of its application.

65 *MacDonald*, supra note 63 (TCC), at paragraph 116.

66 Ibid., at paragraph 101.

67 *MacDonald*, supra note 63 (FCA), at paragraph 27, quoting *RMM*, supra note 36, at 308.

68 *MacDonald*, supra note 63 (FCA), at paragraph 28, quoting the trial decision, supra note 63 (TCC), at paragraph 109.

The Tax Court in *Gwartz v. The Queen*[69] similarly followed the Supreme Court's guidance in *Copthorne* that there is no anti-surplus-stripping scheme in the Act. In *Gwartz*, the taxpayer undertook a series of transactions to convert a taxable dividend into a capital gain, thereby avoiding the "kiddie tax" under section 120.4. The appellants were minors and beneficiaries of a family trust ("the trust"), which held common shares and class C preferred shares of a management corporation ("FHDM") that provided services to Dr. Gwartz's dental practice. In 2003 and 2005, FHDM declared two stock dividends, consisting of an aggregate total of 300,000 class D preferred shares. The class D preferred shares were redeemable at $1 per share, and the cumulative PUC of the class was $2. During the same period, the trust sold 225,000 of the class D preferred shares to Dr. Gwartz in consideration for promissory notes with an aggregate value equal to the FMV of the shares. Dr. Gwartz then sold the shares to an Ontario corporation ("206") that was wholly owned by Dr. Gwartz's spouse, in consideration for promissory notes with an aggregate value equal to the FMV of the shares. FHDM subsequently redeemed the class D preferred shares held by 206. Both sets of notes were repaid out of the redemption proceeds, such that the trust received proceeds equal to $225,000. The trust reported a total capital gain of $224,998.50 on the sale of the class D preferred shares to Dr. Gwartz, and 206 included in its income the deemed dividend it received on the redemption of the class D preferred shares, claiming an offsetting intercorporate dividend deduction under section 112. In effect, a taxable dividend, on which section 120.4 kiddie tax would have been payable if the dividend had been received by the minor beneficiaries of the trust, was converted into a capital gain in respect of which the kiddie tax was (at that time) not applicable.[70]

The Tax Court held that although section 120.4 was circumvented, there was no abuse because there is no policy in the Act against income splitting. The court went on to cite the holding of the Tax Court in *Collins & Aikman* and the Supreme Court in *Copthorne* that there is no anti-surplus-stripping scheme inherent in the Act. Interestingly, the Tax Court noted that the minister "declined to pursue" the position that the taxpayers "contravened a policy in the [Act] against surplus stripping."[71]

Shortly after the decision in *Gwartz*, the Tax Court was again asked to address a surplus-stripping transaction, in *Descarries v. The Queen*.[72] In *Descarries*, the taxpayers held all of the class A shares of a Canadian-resident company ("Oka"). The class A shares had an approximate FMV of $615,000, an approximate ACB of

69 2013 TCC 86.

70 It is noteworthy that the enactment of subsection 120.4(4) subsequently prevented this type of planning by (1) deeming the amount of the taxable capital gain not to be a taxable capital gain to the minor and (2) deeming twice the amount that would otherwise have been a taxable capital gain to be a non-eligible dividend received by the minor.

71 *Gwartz*, supra note 69, at paragraphs 50-51.

72 2014 TCC 75.

$360,000, and PUC of $25,100. The taxpayers exchanged the class A shares for class B and class C shares of Oka pursuant to subsection 85(1), triggering a $255,000 capital gain on the exchange. They then transferred the class B and class C shares to a holding company ("9149") in exchange for class A and class B shares of 9149 on a tax-deferred rollover basis. The 347,848 class A shares of 9149 had an ACB and PUC equal to the FMV of the shares (each $1 per share); the class B shares had a high FMV and ACB ($269,618) and PUC of nil, owing to a PUC grind under section 84.1 in respect of the embedded V-day value of the class B shares (value that had accrued in the Oka shares prior to 1972). Subsequently, 9149 redeemed all of the class A shares and approximately three-quarters of the class B shares. The redemption of the class A shares did not trigger a capital gain or deemed dividend, while the redemption of the class B shares resulted in a deemed dividend and a capital loss of $196,506. The capital loss was used to partially offset a significant portion of the $255,000 capital gain incurred on the original disposition of the class A Oka shares. The subsequent redemption of the remaining class B shares again resulted in a deemed dividend and the realization of a capital loss.

The Tax Court held that the transactions in *Descarries* resulted in an abuse by using soft ACB that accrued prior to 1972 to fund a tax-free distribution on the redemption of the class C shares of 9149. In particular, the court indicated that the capital loss resulting from the redemption of the class B shares, which related to the soft ACB accruing prior to 1972, should not be available to create hard ACB in the class C shares that could be distributed through a deemed dividend.

It must be noted that *Descarries* is an informal procedure case and therefore is not a binding precedent.

In *Univar Holdco Canada ULC v. Canada*,[73] the Federal Court of Appeal held that the taxpayer had implemented a reorganization in connection with an arm's-length transfer of property that was not subject to the application of section 212.1 or GAAR.

Univar unfolded as a result of an arm's-length acquisition by CVC Capital Properties ("CVC") of Univar NV, a Netherlands company that operated a global business in the purchase and resale of chemicals. CVC was particularly interested in an indirect Canadian subsidiary of Univar NV ("Univar Canada"), which had accumulated a significant surplus. Although the shares of Univar Canada had a high FMV and significant accumulated surplus (approximately $890 million), the shares had relatively low PUC (approximately $1 million). Following CVC's acquisition of Univar NV, the corporate structure was reorganized so that the surplus in Univar Canada could be extracted without realizing a gain or triggering a deemed dividend to CVC pursuant to section 212.1. This was achieved by implementing a sandwich structure in which Univar NV held the shares of a US subsidiary ("UHI"), which in turn held the shares of a Canadian subsidiary ("Canada Holdco"). Canada Holdco was capitalized such that its PUC was approximately $210 million and it owed approximately $590 million to UHI (as well as approximately $730 million to Univar NV).

73 2017 FCA 207.

Canada Holdco further held the shares of a second US corporation ("Univar Inc."), which in turn held the shares of Univar Canada.[74] Univar Inc. transferred the shares of Univar Canada to Canada Holdco in satisfaction of the redemption of certain of its shares by Canada Holdco. The Canada-US tax treaty applied to exempt the minimal capital gain arising on such a transfer from Canadian taxation. In addition to avoiding Canadian capital gains tax, the series of transactions fit within the ambit of subsection 212.1(4), such that a section 212.1 deemed dividend was also avoided. As the provision then read, subsection 212.1(4) prevented a deemed dividend or a PUC grind from arising under subsection 212.1(1) where a non-resident corporation transferred the shares of a subsidiary Canadian corporation to its Canadian parent corporation. The implementation of the structure whereby Univar Inc. was sandwiched between Canada Holdco and Univar Canada allowed the taxpayer to access this exception. As a result of the transactions, the amount of capital that could be returned without attracting part XIII withholding tax increased from approximately $1 million to $890 million.

The Tax Court held that the incorporation of a Canadian corporation (that is, Canada Holdco) for the sole purpose of satisfying subsection 212.1(4), and thus avoiding the application of subsection 212.1(1.1), was an avoidance transaction that constituted an abuse of the Act.[75] The Federal Court of Appeal overturned the Tax Court's decision on the ground that the series of transactions flowed from an arm's-length purchase of shares. In reaching its conclusion in this regard, the Federal Court of Appeal held that "the purpose of section 212.1 of the [Act] was not to prevent the removal from Canada, by an arm's length purchaser of a Canadian corporation, of any surplus that such Canadian corporation had accumulated prior to the acquisition of control."[76]

As a result of the decision of the Federal Court of Appeal in *Univar*, subsection 212.1(4) has since been amended such that it does not apply if any shares of a Canadian parent corporation that is acquiring the shares of a Canadian subsidiary are held by a non-resident that does not deal at arm's length with the Canadian parent (that is, where the Canadian parent is itself a subsidiary of a non-resident).

In 2016, the Tax Court applied section 84.1 to a series of transactions in *Poulin v. The Queen*.[77] In *Poulin*, two individuals, Mr. Poulin and Mr. Turgeon, were equal shareholders of a company ("Amiante"). A reorganization was undertaken for the purpose of implementing Mr. Poulin's gradual departure from Amiante. Mr. Turgeon

74 The structure was implemented by the transfer of most of Univar NV's shares in Univar Inc. to UHI in exchange for shares of UHI, followed by the transfer by UHI of the Univar Inc. shares to Canada Holdco in exchange for common shares and a promissory note. Canada Holdco concurrently acquired the remaining shares of Univar Inc. directly from Univar NV for a promissory note.

75 2016 TCC 159.

76 *Univar*, supra note 73, at paragraph 21.

77 2016 TCC 154; aff'd 2017 FCA 103 (sub nom. *Turgeon v. Canada*).

incorporated a wholly owned subsidiary ("Gestion Turgeon"). In 2007, Mr. Poulin sold 450,004 class F shares of Amiante to Gestion Turgeon for $1 per share, satisfied by $45,000 payable to Mr. Poulin and a promissory note in the amount of $405,004, bearing interest at 5 percent per annum and payable in five consecutive annual payments of the greater of $81,000.80 and 90 percent of the sums received by Gestion Turgeon from Amiante. There was an agreement by Amiante to pay its shareholders at least 80 percent of its annual net profits, in the form of dividends or in some other form. The repayment of the note was funded by the redemption by Amiante of the class F shares held by Gestion Turgeon. In 2012, Mr. Poulin sold his remaining interest in Amiante to Gestion Turgeon for $1,370,000. Also in 2007, Mr. Hélie, who had been working as the controller of Amiante since 2004, incorporated a wholly owned subsidiary ("Gestion Hélie"). Mr. Turgeon sold 388,861 class D shares of Amiante to Gestion Hélie for $1 per share, satisfied by the issuance of a promissory note in the amount of $388,861, bearing interest at 4 percent and payable on the basis of the cash flows generated by Amiante (which, as noted, had agreed to pay its shareholders at least 80 percent of its annual net profits in the form of dividends or otherwise). Gestion Hélie committed to paying 90 percent of the sums received from Amiante to Mr. Turgeon. Amiante redeemed most of the class D shares held by Gestion Hélie over a five-year period, and those funds were used to repay the amount owing to Mr. Turgeon. The remaining class D shares held by Gestion Hélie and not redeemed by Amiante were transferred to the parent company of Amiante ("GPI"); it is unclear whether these class D shares were transferred for consideration. Mr. Poulin and Mr. Turgeon each claimed the capital gains deduction under subsection 110.6(2.1) on the sale of their class F shares and class D shares, respectively. The minister reassessed Mr. Poulin and Mr. Turgeon under section 84.1 in respect of the sale of shares in Amiante by Mr. Poulin to Gestion Turgeon and by Mr. Turgeon to Gestion Hélie.

The Tax Court held that section 84.1 did not apply to the sale by Mr. Poulin to Gestion Turgeon on the basis that Mr. Poulin dealt at arm's length with Gestion Turgeon. In its reasoning, the court noted that Mr. Poulin and Mr. Turgeon came to a sale agreement that was intended to facilitate the departure of Mr. Poulin from Amiante, and was arrived at following "arduous negotiations."[78] The court further noted that each of Mr. Poulin and Mr. Turgeon "called upon several independent professionals to better represent their respective interests."[79] However, the court found that Mr. Turgeon and Gestion Hélie were acting in concert and de facto dealing not at arm's length on the basis that (1) "[t]he purpose of that sale was to help Mr. Turgeon claim his capital gains deduction"; (2) "no period was stipulated to repay the promissory note that Gestion Hélie issued to Mr. Turgeon"; (3) as of the hearing date, nine years after the transaction, a balance still remained payable on the promissory note from Gestion Hélie to Mr. Turgeon; and (4) for Mr. Hélie,

78 *Poulin*, supra note 77 (TCC), at paragraph 69.

79 Ibid.

there were no risks involved in participating in the transaction, since Gestion Hélie could force Amiante to redeem the class D shares held by it.[80]

In *Perry Wild v. The Queen*,[81] the taxpayer, Mr. Wild, made use of the PUC averaging mechanism in the Act to offset a PUC grind that had occurred pursuant to section 84.1. The PUC averaging rules provide, in general terms, that PUC is calculated on a class-by-class, rather than a share-by-share, basis. To access the use of this mechanism, Mr. Wild stepped up the ACB of his common shares in a wholly owned small business corporation ("PWR") by transferring a portion of his PWR common shares to two new Holdcos, which were wholly owned by him and his wife, respectively, in exchange for preferred shares of each of the Holdcos. To effect the transfer, Mr. Wild elected under subsection 85(1) at an amount resulting in the realization of a capital gain, which he eliminated through the use of his lifetime capital gains exemption. Consequently, section 84.1 applied to grind the PUC of the preferred shares of the two Holdcos down to a nominal amount. PWR then transferred assets with a high cost base to each of the Holdcos for additional preferred shares of the same class as those that were issued to Mr. Wild. As a result of the PUC averaging rule in subsection 89(1), the PUC of Mr. Wild's preferred shares was increased and the PUC of PWR's shares was effectively decreased. The cross-shareholdings between PWR and the Holdcos were subsequently eliminated.

The Tax Court held that the transactions violated GAAR and abused both section 84.1 and subsection 89(1). In particular, the court found that the transactions abused section 84.1 by allowing Mr. Wild to withdraw PWR's earnings tax-free in excess of the capital he had invested in the company, thereby violating the PUC scheme in the Act. The court stated that the "object, spirit and purpose" of section 84.1

> is to prevent the removal of taxable corporate surplus as a tax-free return of capital through the use of the capital gains exemption (or tax-exempt margin), where there is a non-arm's length transfer of shares by an individual resident in Canada from one corporation to another and PUC in excess of the amount invested cannot be withdrawn tax free.[82]

The Federal Court of Appeal reversed the Tax Court's decision. While the Federal Court of Appeal agreed with the lower court that Mr. Wild had increased the PUC of his Holdco shares, it noted that the surpluses of the Holdcos and PWR had not in fact been extracted by Mr. Wild tax-free, since PWR had not distributed its

80 Ibid., at paragraphs 86 and 96. The analysis in *Poulin* primarily involved the determination of factual non-arm's-length relationships, and did not involve GAAR, nor did the Tax Court undertake a detailed discussion of the object, spirit, and purpose of section 84.1. For a discussion of factual non-arm's-length relationships, see Sandra Mah and Mark Meredith, "Factual Non-Arm's-Length Relationships," in *Report of Proceedings of the Sixty-Sixth Tax Conference*, 2014 Conference Report (Toronto: Canadian Tax Foundation, 2015), 16:1-24.

81 Sub nom. *1245989 Alberta Ltd. v. The Queen*, 2017 TCC 51; rev'd 2018 FCA 114.

82 *1245989 Alberta*, supra note 81 (TCC), at paragraph 68.

retained earnings to either of the Holdcos. In this regard, the court noted the decision of Rothstein J in *OSFC Holdings Ltd. v. Canada*[83] that the pre-packaging of assets with beneficial tax attributes does not result in a tax benefit until such attributes are ultimately realized by the taxpayer. Therefore, the court held that the transactions had not resulted in a tax benefit. However, this may ultimately be a hollow victory for Mr. Wild, since the CRA will surely be lying in wait and will be prepared to apply GAAR if he attempts to use his increased PUC in the Holdco shares to realize the tax benefit that the transactions sought to achieve.

In *Pomerleau v. The Queen*,[84] the taxpayer sought to extract funds from a family-held corporation in order to build a chalet, in the context of an intergenerational transfer of the business. The taxpayer held, among other investments, class A shares and class G shares of his holding company ("P Pom"). The class A shares had hard ACB of approximately $1 million (representing an amount on which tax was paid), a high FMV (approximately $22 million), and nominal PUC. The class G shares had an FMV of approximately $1 million, soft ACB of approximately $1 million (in respect of which the lifetime capital gains exemption was claimed), and nominal PUC. P Pom redeemed all of the class G shares, triggering a deemed dividend of approximately $1 million pursuant to subsection 84(3) and a capital loss in the same amount. The capital loss was denied under subsection 40(3.6) and added to the ACB of the class A shares pursuant to paragraph 53(1)(f.2). This transformed the previously soft ACB in the class G shares into hard ACB in the class A shares for the purposes of section 84.1, since the ACB was created under paragraph 53(1)(f.2) as a result of the capital loss on the share redemption, rather than as a result of a capital gain in respect of which the lifetime capital gains exemption had been claimed. The taxpayer then transferred the class A shares of P Pom to another Holdco ("Gestion") in consideration for class A and class C shares of Gestion. The PUC of the class C shares was set at approximately $2 million, representing the hard ACB of the class A shares of P Pom. The class C shares of Gestion were then redeemed without any adverse tax consequences, because the PUC and the ACB of the shares were equal to the proceeds received on redemption. In effect, the taxpayer was able to extract $2 million of corporate surpluses while paying dividend tax rates on $1 million and not paying tax on the other $1 million.

The Tax Court applied GAAR to the series of transactions, and this decision was upheld by the Federal Court of Appeal. The Tax Court held that the transformation of "what was once a '*soft*' adjusted cost base into a '*hard*' adjusted cost base" violated the object, spirit, and purpose of section 84.1.[85] The Federal Court of Appeal defined the object, spirit, and purpose of section 84.1 even more broadly, stating that "[t]he purpose of section 84.1 is to prevent amounts which have not been subject to

83 2001 FCA 260.

84 2016 TCC 228; aff'd 2018 FCA 129.

85 *Pomerleau*, supra note 84 (TCC), at paragraph 81 (emphasis in original).

tax from being used in order to allow shareholders to withdraw corporate surpluses on a tax-free basis."[86] Although the Federal Court of Appeal's conception of the object, spirit, and purpose of section 84.1 was quite broad, the decision in *Pomerleau* is best understood as preventing a taxpayer from circumventing the application of section 84.1 by converting soft ACB directly or indirectly into hard ACB.

Subsection 84(2): Windups, Discontinuances, and Reorganizations

In addition to decisions on the application of GAAR, jurisprudence relating to subsection 84(2) has created uncertainty for taxpayers. In particular, as a result of the liberal interpretation of the phrase "in any manner whatever" adopted by the Tax Court in *RMM* and subsequently by the Federal Court of Appeal in *MacDonald*, the minister may seek to apply this provision to any extraction of funds from a corporation, whether received directly or indirectly, on the "winding-up, discontinuance or reorganization" of its business.[87] According to the Supreme Court of Canada in *Smythe et al. v. Minister of National Revenue*, a formal liquidation or windup of a corporation is not necessary in order for the corporation to be considered to have wound up or discontinued its business.[88] Regarding whether there is a "reorganization"

86 *Pomerleau*, supra note 84 (FCA), at paragraph 64.

87 In a much earlier case involving the application of a prior version of subsection 84(2), the Federal Court Trial Division similarly adopted a broad interpretation of the provision. In *David v. The Queen*, 75 DTC 5136 (FCTD), the taxpayers were shareholders of a corporation that had disposed of its principal business assets. The corporation did not distribute the proceeds directly to the shareholders; instead, the shareholders sold their shares to the corporation's pension plan several months later. As a result, the shareholders incurred a capital gain on the sale, rather than the deemed dividend that would have been triggered if the proceeds from the disposition had been distributed. The court held that the transaction fell within the ambit of former subsection 84(2), stating that "if any meaning is to be given to the word 'on' it must at the very least mean at the 'same time as' or possibly 'as a result of' or 'consequential to' " (ibid., at 5418). The court then went on to find that even though it was "not at the time of or 'on' the discontinuance of the commercial operations of the company in August that the funds were appropriated for the benefit of the David group but only five months later," it nonetheless was "evident that the Dunn group planned to wind-up not only the commercial but all business of the company immediately after they took over," such that "the winding-up appears to have been part of the plan" (ibid.).

88 [1969] SCR 64. The Supreme Court of Canada stated, ibid., at 70, "There was a winding-up and a discontinuance of the business of the old company, although it is apparent that there was no formal liquidation under the *Winding-Up Act* or the winding-up provisions of the *Ontario Companies Act*." See also *Gilmour v. The Queen*, 81 DTC 5322 (FCTD), in which a holding corporation ("Trident") sold the shares of one of its subsidiaries and distributed the proceeds to its shareholder, in anticipation of the liquidation and winding up of Trident. The Federal Court held, ibid., at 5324, that there was "a winding up, discontinuance or reorganization" of the business, notwithstanding the taxpayers' contention that Trident made certain warranties on the sale of its subsidiary that may have required the shareholders to return the money to Trident and that the amounts paid were therefore only an "advance" to the shareholders.

of a business, in *Kennedy v. MNR*,[89] the Federal Court Trial Division stated that a reorganization involving the transfer of corporate assets will not necessarily constitute a "reorganization" for the purposes of subsection 84(2), so long as the corporation continues to carry on the same business. The court went on to state that "the word 'reorganization' presupposes the conclusion of the conduct of the business in one form and its continuance in a different form."[90] Similarly, in *Geransky v. The Queen*,[91] the Tax Court held that a series of steps undertaken by the taxpayer resulting in the transfer of the assets of one part of the business operated by a corporation to a second corporation did not constitute a "reorganization" for the purposes of subsection 84(2).[92] Bowman J observed that, although "[s]ubsection 84(2) is a reasonably broad section . . . I do not think one can contort it beyond all recognition."[93]

Notwithstanding recent decisions adopting a broad interpretation of subsection 84(2), it should be possible in certain circumstances to avoid its application. The Federal Court of Appeal differentiated its decision in *MacDonald* from the decision of the Tax Court in *McNichol*, stating that in *McNichol* "the financing of the share purchase came from the bank, and Bec's assets remained deposited in its bank account for some time after the amalgamation,"[94] whereas in *MacDonald* the corporation's funds were used to repay the shareholder. Consequently, subsection 84(2)

89 72 DTC 6357 (FCTD); aff'd 73 DTC 5359 (FCA). In this case, the taxpayer was the sole shareholder of a corporation that purchased a property for use in its car dealer business. The corporation subsequently sold the property to the taxpayer, who subsequently leased it back to the corporation for use in its business. The Tax Court held that there was no reorganization, because the same corporation continued the same business in the same manner and form, and a sale of the capital asset was not sufficient to constitute a "reorganization" under subsection 84(2): supra (TCC), at paragraphs 47-49.

90 *Kennedy*, supra note 89 (FCTD), at 6362.

91 2001 DTC 243 (TCC).

92 Ibid., at paragraphs 20-21. In *Geransky*, the taxpayers (two shareholders) held shares in a holding company ("GH") that held shares of an operating company ("GBC"), which carried on a concrete construction business. The taxpayers agreed to sell the cement manufacturing division to an arm's-length party. Prior to the sale, the taxpayers undertook a series of steps to realize their respective capital gains exemptions. Both taxpayers crystallized their capital gains exemptions by transferring a portion of their GH shares to a newly incorporated company ("Newco") in consideration for shares of Newco having a value of $500,000. GBC paid a dividend in kind to GH, which was satisfied by the transfer of the cement plant assets (with an FMV of $1 million). GH redeemed the GH shares held by Newco and satisfied the redemption by transferring the cement plant assets to Newco. Newco was subsequently sold to the third-party purchaser. The Tax Court held, ibid., at paragraph 21, that "[t]here was no discontinuance, wind-up or reorganization of any company's business [as] [b]oth GH and GBC continue to this day to do what they have always done," and that in any case the taxpayer was a shareholder of GH, whose "business . . . is the holding of shares of GBC," and was not a shareholder of GBC itself.

93 Ibid., at paragraph 20.

94 *MacDonald*, supra note 63 (FCA), at paragraph 25.

may not apply where third-party funds, rather than corporate-generated surplus, are used to fund the distribution by the corporation and the corporate surplus remains in the corporation for some time.[95]

As well, subsection 84(2) should not apply where the surplus-stripping transaction involves a company that is carrying on business as a going concern and is not performed in contemplation of a "winding-up, discontinuance or reorganization" of the corporation's business. In this regard, the Federal Court of Appeal in *Perrault v. The Queen* held that a dividend was not paid on the "winding-up, discontinuance or reorganization" of a company's business because, following the payment, the company "continued to carry on business at [one of its plants], albeit on a reduced scale" for over a year.[96] In contrast, in *David v. The Queen*, the Federal Court Trial Division held that a distribution occurred on the discontinuance of the company's commercial operations, even though the funds were appropriated four months after the sale of the company's principal business assets, since "the winding-up appears to have been part of the plan."[97] Similarly, in *Descarries*, the Tax Court held that subsection 84(2) did not apply on the basis that the business continued to operate for a significant period of time (one year and nine months) after the first share redemption occurred.[98]

The Current Position of the CRA

Despite the jurisprudence to the contrary, including the Supreme Court's judgment in *Copthorne*, the CRA maintains the position, and its desire to demonstrate, that there is an anti-surplus-stripping scheme in the Act. Specifically, the CRA is hoping to have the opportunity to argue its position that there is a specific scheme in the Act to tax any distribution or allocation of surplus (after-tax income) of a Canadian corporation as dividends in the hands of its shareholders who are individuals.[99] The CRA has similarly stated that the purpose of section 84.1, along with a number of other provisions in the Act, "is to prevent individual shareholders from indirectly accessing the surplus of a corporation otherwise than as a dividend."[100] The CRA has further noted that, notwithstanding the decisions in *Gwartz*, *Collins & Aikman*, and

95 In *RMM*, supra note 36, at 308, notwithstanding that RMM used a bank loan to fund the purchase of the shares of EL, the Tax Court held that subsection 84(2) applied on the basis that RMM was "an instrumentality used to effect the distribution of property to the shareholder." In analyzing the decision in *RMM*, the Federal Court of Appeal in *MacDonald* specifically noted that while in *RMM* the corporate surplus was used to repay the bank loan within three days of the acquisition, in *McNichol* it was used to repay the bank loan two weeks later: *MacDonald*, supra note 63 (FCA), at paragraphs 25-26.

96 *Perrault v. The Queen*, 78 DTC 6272, at 6277 (FCA).

97 *David*, supra note 87, at 5148.

98 *Descarries*, supra note 72, at paragraphs 29-34.

99 See CRA document no. 2012-0433261E5, June 18, 2013.

100 CRA document no. 2014-0538091C6, October 10, 2014.

Copthorne, it "does not believe that it has had the opportunity to fully state its case regarding surplus stripping."[101]

In our view, there are important differences between the PUC scheme delineated in *Copthorne* and the anti-surplus-stripping scheme described above by the CRA. While the Supreme Court in *Copthorne* stated that the PUC scheme in the Act was intended to prevent "a return of tax-paid investment without inclusion in income,"[102] the court did not specify the required character of the income inclusion; that is, it did not state that the income should be characterized as a dividend in certain circumstances and as a capital gain in others. Rather, it could be inferred that, in stating that there is no anti-surplus-stripping scheme in the Act, the court believed that the characterization of the income inclusion does not matter so long as the transactions do not result in the creation or preservation of PUC where the provisions of the Act clearly did not intend such a result. In contrast, the necessity to characterize the extraction of all corporate surplus as dividend income, regardless of the legal substance of the transaction that gives rise to such extraction, is central to the CRA's characterization of its anti-surplus-stripping scheme. Furthermore, the insistence by the CRA that it has not "had the opportunity to fully state its case regarding surplus stripping" is perhaps a recognition on the part of the CRA that the PUC scheme delineated by the Supreme Court in *Copthorne* differs to some degree from the anti-surplus-stripping scheme for which it advocates.

Unsurprisingly, the CRA has also adopted a broad interpretation of the cases in which the courts have found in its favour. Of particular note is the Federal Court of Appeal's decision in *MacDonald*. The CRA has stated that it will "maintain its position of applying the GAAR and/or subsection 84(2) to cases like *The Queen v. Macdonald* where a taxpayer uses losses or other tax shelter to reduce a capital gain realized as part of a surplus stripping scheme."[103] It is not surprising that the CRA has given this overly broad interpretation to *MacDonald*. However, its position is particularly odd since the Federal Court of Appeal did not opine on GAAR in the *MacDonald* decision, and it concluded that subsection 84(2) applied because the business of the operating company was wound up.

It is worth noting that the CRA has been willing not to apply subsection 84(2) to post mortem pipeline transactions.[104] Generally, such transactions involve the transfer of shares of an Opco (the cost of which is stepped up on the death of the deceased

101 "26 November 2013 Annual CTF Roundtable," at question 13, under the heading "Notes from Presentation," *Tax Interpretations* (https://taxinterpretations.com).

102 *Copthorne*, supra note 11, at paragraph 96.

103 CRA document no. 2015-0610701C6, November 24, 2015.

104 Numerous articles have considered the treatment of such transactions. Some of the more recent articles include S. Dane ZoBell and Stephen A. Miazga, "Succession and Post-Mortem Planning," in *2018 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2018), 5:1-24; Erin Podio and David Stevens, "Update on Post-Mortem Planning," in *2018 Ontario*

under subsection 70(5)) to a Holdco in exchange for a promissory note or "high/high" shares, followed by the amalgamation or windup of Opco into Holdco. An election may be made separately to bump the basis of Opco's capital property to the extent permissible under paragraph 88(1)(d). The CRA has stated that it is its administrative position that such a transaction will be considered permissible so long as (1) the corporation remains a separate and distinct entity for at least one year; (2) during that period, the corporation continues to carry on its business in the same manner as before; and (3) thereafter, the note is repaid, or the PUC of the shares is reduced, on a progressive basis.[105] Although the Tax Court in *MacDonald* indicated that this timeline was "arbitrary,"[106] it appears to be consistent with the decision of the Federal Court of Appeal in *Perrault*. Nonetheless, if the CRA takes the position that there is no windup, discontinuance, or reorganization so long as the taxpayer waits at least one year between the transfer and the liquidation, on principled grounds it would be inconsistent to permit post mortem pipeline transactions while prohibiting transactions similar to the one undertaken in *MacDonald*, provided that the taxpayer waited one year before winding up the business.

KEY TAKEAWAYS FROM THE SURPLUS-STRIPPING JURISPRUDENCE

There are several themes that emerge from the foregoing jurisprudence to determine whether a transaction or a series of transactions violates the PUC scheme identified by the Supreme Court of Canada in *Copthorne*.

First, in accordance with the decisions of the Tax Court and the Federal Court of Appeal in *Wild*, non-arm's-length transactions that use the PUC averaging rules in subsection 89(1) to shift PUC within a particular class of shares to shares held by an individual taxpayer from shares held by other shareholders that are indifferent to reductions in their share of the PUC of the class (such as a corporation that is wholly owned by the taxpayer) may be considered an abuse of the Act.

Second, in accordance with the decision in *Pomerleau*, transactions that convert soft ACB into hard ACB to increase the PUC of a class of shares may contravene the PUC scheme.

Tax Conference (Toronto: Canadian Tax Foundation, 2018), 7:1-38; David Stevens, "Passage of Shares of a Private Corporation on Death," in *Taxation of Private Corporations and Their Shareholders*, 5th ed. (Toronto: Canadian Tax Foundation, 2020), 19:1-68; and Gwen Benjamin and Robert Martini, "Post Mortem Planning: Selected Issues and Planning Tips," in *2011 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2011), 5:1-28.

105 See, for example, CRA document no. 2011-0401861C6, June 2, 2011.

106 *MacDonald*, supra note 63 (TCC), at paragraph 80. The court pointed out, ibid., at paragraph 79, that the CRA's position regarding the "post-mortem plan clearly parallels the Appellant's tax plan in the case at bar," and that "[t]he conditions imposed on the post-mortem transactions, if imposed in the case at bar, would show that the CRA's assessing practice was consistent in trying to apply subsection 84(2)."

Third, a court will likely apply GAAR to transactions undertaken to sidestep the "connected" rules in subsection 186(4) with the aim of circumventing section 84.1, as was attempted by the taxpayer in *Desmarais*.

Fourth, it is noteworthy that the courts have generally refrained from applying GAAR to surplus-stripping transactions where those transactions involved arm's-length transfers.[107] In *McMullen*, the taxpayer and his business associate were severing their business relationship and therefore had differing interests that caused them to be acting at arm's length. In refusing to apply GAAR, the court found that none of the transactions in the series was an avoidance transaction because each transaction was undertaken for the bona fide non-tax purpose of separating the business. Furthermore, in *Univar*, the Federal Court of Appeal held that the series of transactions resulting in the avoidance of section 212.1 did not violate GAAR since the series of transactions flowed from an arm's-length purchase of shares, a context in which section 212.1 did not apply. In contrast, the courts have been less sympathetic where the context of the transactions involved a transfer to a non-arm's-length person. For example, in *Pomerleau*, the taxpayer argued that the overall purpose of the transactions was to effect an intergenerational transfer of the business. Although this case was decided on different grounds—namely, that the taxpayer attempted to convert soft ACB into hard ACB—the Federal Court of Appeal noted in obiter that section 84.1 does not reveal an intent that its application may be bypassed in the case of intergenerational transfers of family businesses, which fall within the category of non-arm's-length transfers.[108] It is noted that *McNichol*

107 See, for example, *Brouillette v. The Queen*, 2005 TCC 203, at paragraph 55. In *Brouillette*, Mr. Brouillette and Mr. Ferland each owned 50 percent of the issued and outstanding shares of a Canadian-resident corporation ("Brouillette Automobiles"). Mr. Ferland and Mr. Brouillette sought to sever their business relationship and agreed that Mr. Brouillette would acquire Mr. Ferland's shares. The bank refused to lend the cash to Brouillette Automobiles to fund the acquisition. In light of the bank's refusal, Mr. Brouillette sought to bring two new shareholders into the business (Mr. Chagnon and Mr. Brunet) to replace Mr. Ferland. Mr. Brouillette incorporated a Canadian-resident corporation ("9016") and subscribed for class A and class C shares, which represented 51 percent of the voting shares of 9016. Mr. Chagnon and Mr. Brunet were equal shareholders in another Canadian-resident corporation ("9017"), which held class A and class G shares of 9016. The National Bank of Canada loaned $490,000 to Brouillette Automobiles, of which $75,000 was paid to Mr. Ferland as a retiring allowance and $400,000 was loaned to 9016 to partially fund the purchase of the shares of Brouillette Automobiles held by Mr. Ferland. On the same day, Mr. Brouillette transferred his shares in Brouillette Automobiles to 9016 in consideration for 500,000 non-voting class E shares, on a tax-deferred basis, after which 9016 became the sole shareholder of Brouillette Automobiles. Following disagreements related to the operation of the business with Mr. Brouillette, Mr. Chagnon and Mr. Brunet agreed to cause 9017 to acquire Mr. Brouillette's class E shares in 9016 in exchange for a non-interest-bearing promissory note that was to be paid off over a period of five years (although the note was actually paid off in two years). The Tax Court held that neither section 84.1 nor GAAR should apply to the sale to 9017 of the class E shares of 9016 held by Mr. Brouillette, on the basis that the parties dealt at arm's length.

108 *Pomerleau*, supra note 84 (FCA), at paragraph 80.

involved an arm's-length transfer, the terms of which were subject to significant negotiation, yet the Tax Court applied GAAR to deny the benefit received by the appellants. In light of the evolution of the jurisprudence, and the subsequent GAAR test set out by the Supreme Court, *McNichol* is arguably no longer an accurate representation of the law in this respect.[109]

CONCLUSION: THE PERMISSIBILITY OF SURPLUS STRIPPING

For a short time, when amendments to section 84.1 and the addition of section 246.1 were proposed, there was the possibility that permissible surplus stripping was going to be legislatively curtailed, resulting in some collateral damage to other commercial transactions. However, with the subsequent withdrawal of those proposals, the jurisprudence over the past 20 years, summarized above, continues to be highly relevant in determining the framework for permitted surplus-stripping transactions.

Although the courts have sought to apply the PUC scheme to transactions involving surplus stripping, there are clear boundaries to its application. Where tax is paid at capital gains rates and the transactions fall outside the bright-line tests delineated in section 84.1, section 212.1, and subsection 84(2), the courts should not find that the transaction or series of transactions violates the PUC scheme and therefore GAAR. For instance, the three examples described below should continue to fit within these guidelines.

Example 1
An individual, Mr. A, exchanges some of the common shares he holds in his operating company, A Co, for preferred shares and triggers a gain on the transfer by electing under subsection 85(1). Mr. A pays capital gains tax in respect of the gain on the transfer. He subsequently transfers the preferred shares to a holding company, B Co, in exchange for a promissory note. A Co redeems the preferred shares and B Co repays the principal of the note. At all times, A Co continues to carry on its business.

Example 2
An individual, Mr. X, transfers some of the common shares he holds in his operating company, X Co, to his uncle, Mr. Y, in exchange for a promissory note equal to the FMV of the transferred shares. Mr. X pays capital gains tax in respect of the gain on the transfer. Mr. Y subsequently transfers the common shares of X Co to his holding company, Y Co, in exchange for a promissory note. X Co then redeems the common shares held by Y Co; Y Co uses the funds received from X Co to repay the promissory note owing to Mr. Y; and Mr. Y repays the promissory note owing to Mr. X. At all times, X Co continues to carry on its business.

109 See, for example, *Collins & Aikman*, supra note 51 (TCC), at paragraphs 74-78, where the court noted that *McNichol* was no longer an accurate description of the law.

Example 3
An individual, Ms. R, owns all of the issued and outstanding common shares of R Co, which holds capital assets with unrealized gains. R Co forms a new corporation, S Co, and transfers the capital assets with unrealized gains to S Co in exchange for common shares of S Co. A capital gain is realized on the transfer of the assets. The assets are subsequently leased back to R Co. R Co pays a dividend to Ms. R equal to the capital dividend account (CDA) balance in R Co.

In example 1, Mr. A pays tax in respect of each share on the exchange of his common shares for preferred shares of A Co, albeit at a capital gains rate rather than a dividend rate. As a result, hard ACB is legitimately created on the preferred shares for the purposes of section 84.1. Therefore, when Mr. A transfers the preferred shares to B Co in consideration for the note, no deemed dividend should result under section 84.1 In a 2006 ruling, the CRA opined on a substantively identical transaction, stating that it would seek to apply GAAR because the transaction constituted "a mechanism for the stripping of surplus of [the] corporation."[110] However, the proposition that a transaction such as the one described above would violate GAAR would disregard the Supreme Court's pronouncement in *Copthorne* that there is no anti-surplus-stripping scheme in the Act.

The facts in example 2 are almost identical to the facts in *MacDonald*. Similar to example 1, in example 2 Mr. X pays tax in respect of each share that subsequently contributes to the PUC bump on the transfer by Mr. Y to his holding company, again at a capital gains rate rather than a dividend rate. Moreover, notwithstanding the courts' willingness to apply GAAR in certain non-arm's-length situations,[111] because the same result could be achieved by other means (namely, the transactions set out in example 1), there is a strong argument that GAAR should not apply in the circumstances described in example 2.

In example 3, as a result of the transfer and capital gain consequently realized, R Co will be required to pay capital gains tax on the sale of the assets. The disposition should cause an increase in R Co's CDA balance, and R Co should be able to distribute funds to Ms. R to the extent of such balance. In this scenario, there is no concern regarding the application of section 84.1 since the transferor is a corporation, not an individual, and the objective is to create additional CDA balance, not PUC. GAAR should also not apply since the CDA balance is increased as a result of a disposition in respect of which tax has been paid. It is noteworthy that the CRA has stated that it will not seek to apply GAAR to transactions where there is a deliberate triggering of a capital gain in order to distribute a capital dividend to shareholders.[112]

110 CRA document no. 2004-0099201R3, April 26, 2006.

111 Although uncles and nephews are not "related" persons as that term is defined in section 251, in this situation it is presumed that they are considered to be dealing not at arm's length as a question of fact, pursuant to paragraph 251(1)(c).

112 See Suzanne Saydeh's remarks in "How the Government Has Dealt with the GAAR," presentation at The General Anti-Avoidance Rule: Past and Future, conference held by the

The CRA could seek to apply subsection 84(2) to transactions similar to those in examples 1 and 2, but if the businesses are carried on as a going concern, subsection 84(2) should not apply.[113] In this regard and in accordance with *Perrault*, subsection 84(2) should not apply provided that the company continues to carry on its business for at least one year, even if it does so at reduced activity levels. As well, given the decision of the Federal Court of Appeal in *MacDonald* and consistent with the Tax Court's decision in *McNichol*, in examples 1 and 2 it may be possible to avoid the application of subsection 84(2) provided that the company funds the distribution with third-party money.[114] In example 3, there is a risk that the series of transactions would constitute a "reorganization" under subsection 84(2). However, on the basis of the decisions in *Geransky* and *Kennedy*, the sale of the capital assets in and of itself should not constitute a reorganization for the purposes of subsection 84(2) provided that R Co continues to carry on the same business.

In sum, although the Tax Court and the Federal Court of Appeal have held that various types of transactions result in an abuse of the PUC scheme and therefore violate GAAR, in light of the Supreme Court's position that there is no anti-surplus-stripping scheme in the Act, there are limits on the type of transactions that violate the PUC scheme. Therefore, subject to any new pronouncements by the Supreme Court regarding an anti-surplus-stripping scheme, or new legislative amendments, and provided that the transactions do not run afoul of subsection 84(2), the transactions described in the three examples above should continue to be permissible.

Canadian Tax Foundation, March 7, 2019, citing the CRA's response in CRA document no. 2015-0610701C6, November 24, 2015. This technical interpretation involved a series of transactions whereby an individual transferred the shares of its Opco to a Holdco in consideration for shares of Holdco. A portion of the FMV of the shares of Opco was attributable to something other than safe income on hand. Opco subsequently redeemed the Opco shares held by Holdco, and no designation was made under former paragraph 55(5)(f), such that the entire amount of the dividend was recharacterized as a capital gain. The CRA stated, "The GAAR Committee was of the view that it would be unlikely that the GAAR could be successfully applied to the Transactions given the current state of the jurisprudence." As a result of certain amendments in 2016 that introduced the "bifurcation rules" in paragraph 55(5)(f), and subsection 55(2.3) (which prevents a shareholder's CDA from being increased through the payment of an intercorporate dividend attributable to safe income that contributes to an unrealized capital gain on the shares), it seems that this type of planning is no longer available. However, this should not prevent corporations from triggering a capital gain to increase their CDA account in other ways.

113 Subsection 84(2) should have no adverse application for example 3 since distributions in that scenario are paid to the shareholder as taxable and capital dividends.

114 As noted above, the decision in *RMM* would need to be carefully considered to determine the application of subsection 84(2) in this context.