# *Surplus Stripping*

H. Heward Stikeman and Robert Couzin*

**PRÉCIS**

Le dépouillement des surplus est un sujet continuel d'évitement fiscal. Le phénomène découle de l'imposition discriminatoire des surplus des sociétés matérialisés par voie de distributions ou d'une autre manière, normalement à titre de gain à la vente d'actions. Les auteurs examinent d'abord les questions de politiques fiscales sous-jacentes et ils présentent ensuite un examen historique général des nombreuses modifications législatives portant sur la distribution des surplus des sociétés, en insistant sur des mesures visant spécifiquement à entraver ou à empêcher le dépouillement des surplus. Cet examen porte sur la période comprise entre l'instauration de l'imposition des revenus au Canada en 1917 jusqu'à aujourd'hui.

Les auteurs examinent la situation actuelle au moyen d'un exemple d'une opération de dépouillement des surplus effectuée par un non-résident du Canada. Leur analyse est fondée sur les principes généraux de l'affaire *Smythe*, des dispositions anti-évitement précises et la RGAÉ. Les auteurs concluent qu'un certain nombre d'opérations usuelles de dépouillement des surplus pourraient survivre à l'application de ces dispositions.

En conclusion, les auteurs demandent que des améliorations soient apportées à la logique du régime fiscal et à son application et expliquent le comportement axé sur le marché des contribuables qui cherchent à maximiser toute occasion possible de profiter des écarts.

**ABSTRACT**

Surplus stripping is a perennial tax avoidance topic. The phenomenon depends upon the differential taxation of corporate surplus realized through distribution or in some other fashion, normally as a gain on the sale of shares. The authors begin with a consideration of underlying tax policy considerations and then provide a general historical review of numerous legislative amendments relating to the distribution of corporate surplus, focusing on measures specifically designed to impede or prevent surplus stripping. That review covers the period from the introduction of income taxation in Canada in 1917 to the present.

* H. Heward Stikeman is a founding partner of Stikeman Elliott. Robert Couzin is with the Paris correspondent office of Stikeman Elliott.

The authors examine the current situation by considering an example of a surplus-stripping transaction effected by a non-resident of Canada. Their analysis applies the general principles of the *Smythe* case, specific anti-avoidance provisions, and the GAAR. The authors conclude that a number of common surplus-stripping operations could well survive the application of these provisions.

The article concludes with a call for improvements to the internal logic of the tax system and its administration, and a justification of taxpayer behaviour that is market-oriented and seeks to maximize any remaining arbitrage opportunities.

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> Time present and time past
> Are both perhaps present in time future,
> And time future contained in time past.
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> T.S. Eliot, *Four Quartets*

One of the most longstanding and persistent sources of conflict between taxpayers and tax collectors is the practice commonly known as surplus stripping or dividend stripping. This subject is as topical as it is perennial. Taxpayers seem ever prepared to engage in complex and costly transactions to extract surplus from corporations. Surplus stripping is a natural and, we will suggest, not necessarily an unhealthy response to distortions in the tax system.

Accumulated corporate earnings can be "stripped" only if the law differentiates between the consequences of realizing such income as dividends and the consequences of realizing it in some other way. Stripping is, then, no different from other tax-avoidance or tax-mitigation behaviour. The tax policy substratum of dividend stripping relates to the deferral of taxation of corporate income, the double taxation of corporate income, and the treatment of gains. We will therefore begin our remarks with a review of the policy issues. We will then undertake a historical odyssey through the Canadian experience to explain why things unfolded as they did. It will appear that the current juncture is the result of a dialectical interaction between taxpayers and their advisers on the one hand and tax administrators and legislators on the other. In less fulsome language, it is the fox-and-hounds phenomenon. In the third section of this paper we will examine surplus stripping today. The scope of this analysis is restricted to current (although not time-bound) examples relating to the sale of shares by non-residents. The last section of the paper is a prediction or prescription for the future.

## TAX AVOIDANCE AND TAX POLICY

Tax evasion is cheating. Tax avoidance, with or without opprobrium attached, consists in paying less tax by adopting a particular means of achieving a desired end. Courts and tax administrations distinguish between acceptable tax mitigation and unacceptable scheming. In reality,

there is a gamut of tax-avoidance behaviour that does not fall into neat and distinct categories. Tax avoidance is the natural consequence of alternative paths with different tax costs. The geodesic line may be the shortest distance between two points, but it is not always the cheapest. "Avoidance" is usually reserved for situations in which some change in the form of an activity, organization, or asset is made in order to escape the tax that would otherwise apply.[1] The emphasis on a "change" in behaviour presupposes a priority among commercial alternatives determined without regard to taxation.

We will return to that theme in these remarks, since it is inherent in the very concept of surplus stripping. A related issue, or perhaps the same issue expressed another way, is whether taxpayers should be permitted to "circumvent" provisions of the Act. This is standing the Duke of Westminster on his head: the taxpayer who fails to circumvent the rule pays the tax.

In earlier periods, choosing the lightly taxed alternative would have been accepted as normal, even meritorious. Our tax morality, like most other types of modern morality, has become more complex and ambiguous, less transparent and unidimensional. The duke negotiated with his gardener to achieve a deduction for personal expenses, but his progeny would have some difficulty obtaining a favourable tax ruling or opinion today.

Surplus stripping is considered to occur when a shareholder takes a shortcut in accessing accumulated surplus of a corporation. This has generally meant choosing to realize the economic value of such surplus through a transaction characterized as a sale of shares that gives rise to a capital gain, rather than a distribution from the corporation that is taxed as a dividend. Any behaviour that chooses the more lightly taxed alternative is tax avoidance, but that epithet is often reserved for the case where the road not taken was "normal" and the course adopted bears some marks of artificiality, abnormality, contrivance, or, heaven forbid, creativity. In order to make such judgments about surplus stripping, one must first reconsider the taxation of corporate income.

We will not review the arguments, but accept without further discussion the dominant view that the corporate income tax serves a withholding function, to prevent (or at least to reduce) the benefit of deferral in respect of corporate income to shareholders.[2] The differential between the corporate rate (the withholding tax) and the personal rate (the final tax)

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[1] This formulation derives from the Carter commission report. Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966), 21.

[2] See Robin W. Boadway, Neil Bruce, and Jack M. Mintz, *Taxes on Capital Income in Canada: Analysis and Policy*, Canadian Tax Paper no. 80 (Canadian Tax Foundation, 1987), 35-41; and Organisation for Economic Co-operation and Development, *Taxing Profits in a Global Economy* (Paris: OECD, 1991), 22-24. Another argument for imposing extra tax on income earned in a corporation is based on the theory of economic rents. Proponents of this position argue that a benefit arises from incorporation (which in turn is derived from the state), and some fiscal friction is therefore justified. We are unconvinced of the merits of the proposition, and even less convinced that it is a reason for having an income (as opposed to capital or franchise) tax.

has varied widely over the history of income taxation in Canada. If the corporate tax is substantially less onerous than the personal tax, the withholding function is only partially successful. Tax law will inexorably change the distribution policies of corporate entities; the invisible fiscal hand will cause surplus to accumulate. Ways will be sought and found to obtain some personal use of or benefit from those accumulations of wealth in closely held companies. Among the various policy responses are taxes on undue accumulations of retained earnings, special taxes on investment in non-business assets, and transparency rules such as the former personal corporation system.

Technically speaking, this problem is distinct from that of surplus stripping, but the two go together in a fundamental way. If the corporate (withholding) tax is equal to the personal tax, there is no deferral benefit. There should, logically, be no further tax when the shareholder gains access to the corporate profits. If there is, a shareholder's attempts to avoid such tax are not only natural but laudable. The history of anti-surplus-stripping legislation and practice is intimately linked with the ups and downs of accumulated profits taxation. Surplus stripping presupposes that profits may indeed be accumulated.

Ideally, the realization of accumulated corporate surplus by the shareholder should be fully taxed but offset by a credit for the corporate tax traceable to these earnings. In theory, merely setting the corporate and personal tax rates at the same level and exempting dividends from taxation would have the same effect, but that rarely works in practice, so we look for systems of integrating the withholding and the final tax. Perfect shareholder/corporation integration would entail the same tax result, regardless of the form of the transaction whereby the accumulated earnings are realized. Under such a system, there could be no surplus stripping. Surplus stripping presupposes that corporate distributions are taxed, and taxed more heavily, at least in certain contexts, than alternative means of realizing the value of accumulated earnings.

The distinction between a realization of value funded by the corporation (dividend) and realization funded by an arm's-length purchaser (gain) seems so fundamental that we sometimes lose track of their equivalency. Since corporate income is only subject to corporate (withholding) tax as earned, there is a tax deferral if the personal rate is higher than the corporate rate. In a perfect integration system, the shareholder would receive credit for the corporate tax whether the realization of surplus occurred by distribution or by sale. In either case, the result would be to terminate the deferral by imposing a net tax equal to the differential between the personal and corporate rate. There would be no incentive for surplus stripping. However, while a few countries exempt gains from the sale of corporate participations in affiliates, none seems to provide an imputation credit for gains as for a direct distribution of corporate income.

The converse observation is that countries do not attempt, in their taxation of gains on the sale of corporate shares, to recoup the economic benefit of deferral. It is not practical to offset that advantage by adjusting

the rate of tax on capital gains (since holding periods vary), and no jurisdiction seems to have tried more sophisticated schemes to attack the timing benefit.

Thus, there are imperfections in both directions. What concerns us here is the circumstance in which a realized (as opposed to a deferred) gain is preferred to a dividend distribution. This can be the result of an express rate advantage. Thus, before 1972 capital gains were free of tax and dividends were fully taxable, subject to a crude form of dividend tax credit. After 1985, a similar rate gap was created by the capital gains exemption. There are also more subtle examples. Many shareholders do not get the benefit of the imputation of corporate tax because of their peculiar tax regime, making dividends more expensive. The obvious cases are non-residents and tax-exempts. For them, the corporate tax is a final tax, not an indirect withholding. Non-residents in receipt of dividend distributions actually suffer three final taxes: Canadian corporate tax, non-resident withholding tax, and home country dividend tax (which may provide full or partial recognition for the Canadian taxes). The non-resident dividend withholding tax bears no discernible relation to Canadian individual income tax. Compare the capital gain on a sale of shares: here, the non-resident may be subject to Canadian tax or exempt from tax entirely under the terms of a bilateral tax treaty. It is apparent that a comparison of these two tax regimes will be difficult from the point of view of principle, because there is not a great deal of principle to be found.

## THE ANNALS OF CANADIAN DIVIDEND STRIPPING: TIME PAST

There are many lessons to be drawn from the legislative history in Canada. In addition, some of the historical events, such as the *Smythe* case,[3] still represent important parts of the current law on surplus stripping. Therefore, we cannot escape at least an abbreviated look at what went before.

### Before 1972

The serious student of surplus stripping should not ignore the subject's early history. It is well summarized elsewhere.[4] We merely note a few highlights, which will help us to understand the current state and potential future development of the law. It is apparent that from the very beginning, in the now familiar process of squeezing the fiscal balloon, legislative enactment followed upon legislative enactment. As the problem of surplus extraction without dividend taxation was repressed in one place, it popped up somewhere else.

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[3] Infra footnote 9.

[4] See appendix D to the Carter commission report, supra footnote 1. Also interesting, partly for its tone and its expression of the early 1960s *zeitgeist*, is an article one of us wrote in 1961: H. Heward Stikeman, "Ability To Pay," in *Report of Proceedings of the Fifteenth Tax Conference*, 1961 Conference Report (Toronto: Canadian Tax Foundation, 1962), 23-41.

At the beginning, in 1917, there was no double taxation of corporate income. Dividends received by individuals from taxable corporations were exempt. What seems complicated now was simple then, because the basic corporate and individual tax rates were the same. But individuals also paid a graduated surtax, and so the exclusion of dividends from income applied only to the normal tax. That was logical, but it created an incentive to retain earnings in the corporation in order to defer surtax. Therefore, the statute also contained a deemed distribution rule applicable, for surtax purposes only, to all corporate income unless the minister was of the opinion that the accumulation was not in excess of the reasonable needs of the business.

Paradise was closed a few years later when dividends became fully taxable. Full integration gave way to full double taxation. This is sometimes explained away on the basis that rates were so much lower that such imperfections did not matter. However, it is a mistake to think of rates as low merely because we have seen them so high. Taxpayers (and legislators) probably did not view things that way. The Ives commission, reporting years later in 1945, saw this rule of double taxation as evidence that the corporation was being thought of more and more as a separate entity.[5] Such a conclusion sounds quaint to the modern ear, but remember that corporate personality is not so ancient as one might suppose. The *locus classicus*, *Salomon v. Salomon*,[6] was only 20 years old when Canada got its first income tax legislation. The treatment of corporations and their shareholders as entirely separate taxpayers was (is) not obvious.

The battle against dividend stripping really began when, having decided to tax the corporation quite separately from the shareholder, and with rates going up, the legislator also tackled the multiple tax problems that could arise from the increasingly complex structure of corporate groups. So it was that intercorporate dividends came to be exempted.

That same series of amendments ensconced a fundamental distinction between receipt of property from the corporation and receipt of sale proceeds from a new owner. The redemption of shares, or the liquidation of a corporation, did not always give rise to deemed dividends. Case law suggested that such receipts were capital, so the statute deemed them to be income.[7] Another surplus-stripping innovation of this period, or at least so categorized thereafter, was the rule deeming certain loans to shareholders to be dividends.

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[5] Canada, *Report of the Royal Commission on the Taxation of Annuities and Family Corporations* (Ottawa: King's Printer, 1945), 53 (the Ives commission).

[6] [1897] AC 22 (HL).

[7] These are the predecessors to today's section 84, but also various corporate benefit provisions, corporate distributions tax, etc. In addition to appendix D to the Carter commission report, supra footnote 1, see Robert Couzin, "Intercorporate Distributions," in *Report of Proceedings of the Thirty-Fourth Tax Conference*, 1982 Conference Report (Toronto: Canadian Tax Foundation, 1983), 311-56, at 312-28.

These amendments also brought the first express dividend-stripping rule. Section 14 of the Income War Tax Act provided that the seller was taxable on proceeds of sale of shares of a corporation transferred to another corporation acting as agent, promoted by the seller or controlled by him, which second corporation subsequently received a dividend from the first corporation and applied the income in payment of the price. Twenty years later the Ives commission concluded that, but for that rule, the basic surplus strip worked.[8] For transactions that escaped this rule, another was added in the 1930s which provided that if substantially all the shares of a company having undistributed income on hand were purchased by another company, and the main purpose of the sale was to avoid tax, the result could be reversed, but only with Treasury Board approval. The provision was never applied.

That commission, looking back over this history and the tensions it created, recommended a provision permitting the distribution of surpluses by closely held corporations at special low rates of tax payable by the company. This was the first of many such provisions enacted in an effort to offset the incentive to retain profits in corporations, or to strip them without paying distribution tax.

Designated surplus was discovered in 1950 in an attempt to freeze earnings in a corporation upon an acquisition of control and to prevent their withdrawal as a tax-free intercorporate dividend. The idea was to stop individuals from converting inchoate taxable dividends into tax-free gains by selling a corporation with accumulated earnings to another company. Designated surplus was perceived as a complete cure to the disease, and so the specific surplus-stripping rule enacted in the 1920s was repealed.

In the 1950s further provisions were added, permitting distributions at fixed tax cost in certain cases, such as payments of redemption premiums or payments to non-residents or tax-exempt bodies.

In 1963, a frustrated tax administration resorted to a discretionary anti-stripping rule known to the reader, depending upon his or her age, as former section 138A or subsection 247(1) (as renumbered in the post-1971 Act).

One can see from this history that attempts to force taxpayers to realize accumulated corporate surplus as fully taxable dividends rather than tax-free gains lead to volcanic pressures that must be relieved. If the statute did not cleave a furrow for the outpouring lava, taxpayers would make their own. Thus, in its various guises, the legislation often permitted the distribution of such surplus at something less than a full tax rate. One could argue that these early windows of opportunity were the precursors of more sophisticated regimes to integrate shareholder and corporation taxes. But they were really dictated by the pragmatic desire to help taxpayers resist the temptation of surplus stripping.

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[8] Supra footnote 5, at 55.

It is hardly surprising that intrepid taxpayers and their alchemistic advisers still sought ways to reduce the tax on distributions. This was more than just a case of water seeking its lowest level. The dividend system was in fact penal. If accumulated earnings could be sold free of income tax, even altruistic taxpayers, let alone real ones, would be expected to shun heavy taxation of the same income. Here is our first exposure to a common theme. The pejorative "surplus stripping" presupposes that the dividend is "normal" and the gain "contrived." Yet how can one judge which tax result is to be preferred (theoretically speaking, of course, since the practical preference is obvious)? Why is it appropriate to have an infinitely higher rate of tax applicable to distributions compared to realization of the same income on sale?

Another theme that emerges from the pre-1972 experience is that safety valves with a toll charge do not work, especially if their enactment is unpredictable. Allowing surplus to be distributed at a cost lower than ordinary tax but still higher than (free) capital gains may have been good enough for some taxpayers, but not for all, and not forever. So it was that, in the period up to (and even after) the enactment of the discretionary provision in 1963, the dividend strippers became hyperactive.

Many thought that years of inactivity implied acquiescence by the tax administration, but that turned out to be a miscalculation. Revenue took on the more obvious strips, and won. The seminal decision is *Smythe*.[9] The facts are somewhat complex, but the overall effect of the transactions was clear enough. Shareholders started out with an active business company. When the smoke cleared, they still had an active business company with the same business assets (albeit a different company),[10] and cash or cash equivalent equal to the undistributed income of the old company. That old company had sold its assets (tax-free in those days) to a new company, and a third-party stripper had bought the old company from the shareholders. Thus, the shareholders attempted to monetize the undistributed income as a tax-free capital gain and to retain the same business they had before. The Supreme Court of Canada found this to be a winding up, discontinuation, or reorganization of the business, and the cash was therefore a dividend by virtue of the predecessor to subsection 84(2).

Following *Smythe*, federal and provincial tax administrators were deluged with files for settlement. It is more than an interesting historical footnote to observe that many or most such cases were resolved without applying the rigours of the Supreme Court's decision. In 1966, the minister of national revenue, Edgar Benson, offered shareholders involved in such schemes an opportunity to settle by paying a tax of 20 percent of the "dividend." As he noted in the settlement offer, the effective rate was really 16⅔ percent on the undistributed income.

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[9] *C.S. Smythe et al. v. MNR*, [1969] CTC 558 (SCC).

[10] Younger readers will not remember the suspicion aroused in tax auditors by corporations whose name included "(year)," which often indicated a successor by surplus strip.

Perhaps it is surprising that there were not more court cases.[11] Instead, the practice regarding surplus stripping developed through a series of administrative statements, speeches, and rulings.

## 1972 to GAAR

A few milestones in the era following tax reform are also worth noting.

The somewhat ineffective (but comprehensible) rules concerning designated surplus were replaced in 1972 by what must be considered a landmark in the (downward) trend of Canadian tax legislation. The new designated surplus rules were certainly more effective, if for no other reason than that few professionals dared to claim an understanding of the provisions. Never litigated, rarely even contested with Revenue, the new designated surplus system operated *in terrorem* by its sheer complexity. The rules were repealed in 1977.

Yet another system permitting the extraction of corporate surplus at a fixed tax cost was enacted—the "tax-paid undistributed surplus." Pre-1972 earnings could be paid out free of shareholder tax if a 15 percent levy was paid by the distributing corporation.

The continuing tax reform of the 1970s brought a new degree of sophistication to the deemed dividend provisions dating back to the 1920s. The "paid-up capital deficiency" and "debt limit" system provided a much finer and more effective means of preventing indirect distributions of corporate earnings as capital gain. The overly sophisticated rules were repealed in 1977. However, the underlying concept lives on.[12]

Subsection 247(1) was redrafted in 1985. In response to longstanding professional criticism, it ceased to be discretionary. Some were concerned that this could actually make matters worse, as now, perhaps, the subsection would actually be used. That did not happen. There was still no litigation on the merits, in marked contrast to the companion discretion to associate corporations, which gave rise to a substantial jurisprudence.

There were other amendments that one might categorize as part of the surplus-stripping arsenal, such as additional deemed dividend provisions affecting the reduction of capital by public corporations and the special tax on corporate distributions.[13] These rules eroded the basic principle that what is invested in a corporation as capital *can* be withdrawn without distribution tax.

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[11] See *W.L. Craddock et al. v. MNR*, [1969] CTC 566, decided by the Supreme Court of Canada at the same time and for the same reasons as *Smythe*. The only other substantive decision is *M., R. and Y. Giguère v. MNR*, [1972] CTC 2466 (TRB). The other section 138A case was *H. Champagne v. MNR*, [1978] CTC 2967 (TRB), but it was decided on a procedural ground.

[12] See the current sections 84.1 and 212.1 of the Income Tax Act, 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. The attempt to allow deferral of the deemed dividend by reducing the cost base of indebtedness, the debt limit, was abandoned.

[13] Subsection 84(4.1) and part II.1.

There was a time, during the late 1970s, when Finance officials managed to manipulate the tax rates and the gross-up and credit rules so that, at least for a wide body of cases and a substantial class of shareholders, there was no particular advantage in converting dividends to gains (or vice versa).[14] It was never perfect, because the tax system applies differently to different circumstances, and it did not last. The capital gains exemption in 1985 drove a wedge into the system equivalent to what had existed before 1972.

During this period, Revenue officials were helpful in publicizing the department's views on surplus stripping. These statements were made to explain the circumstances in which recourse would be had to subsection 247(1). However, they expressed more generally the official attitude toward surplus stripping. The difficulties encountered in drawing sharp lines are both instructive and revealing.

The first phase was the period shortly after the 1971 reform. Capital gains taxation included a step-up of cost base to valuation day value, and a corporate surplus distribution system to match (1971 capital surplus on hand). This led to a new class of surplus-stripping problems. In addition, Revenue had to adjust its position under subsection 247(1) to keep pace with legislative change concerning paid-up capital deficiency and debt limit. Even so, the outlines of a conceptual policy were already emerging. By 1975, a continuum had been established. At one end was the "classic" strip, a sale of shares of an operating company to a new company controlled by the seller. At the other was the innocent arm's-length disposition. In between, the department turned thumbs down on cases where the economic interest in the purchasing corporation was held for the benefit of the seller or his or her family, but might accept situations where the purchasing company was owned by adult relatives who participated in the business. The specific statutory surplus-stripping rules (sections 84.1 and 212.1) complicated matters because they extended to circumstances that actually fell outside the administrative policy. Not only would the rigours of the law apply to such cases, but subsection 247(1) would be used to attack schemes designed to circumvent those rules, even though what was accomplished did not appear offensive as such. The hopeful administrative attitude was that all the new rules regarding deemed dividends and designated surplus might, in the "mature" system (once the valuation-day issues had receded), render the use of subsection 247(1) unnecessary—although it would be retained, the department suggested, just in case.[15]

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[14] The department could even say in 1978 that, given the rates, subsection 247(1) would no longer apply where a resident shareholder arranged to receive post-1971 earnings as a capital gain rather than as a dividend. J.R. Robertson, "Recent Developments in Federal Taxation," in *Report of Proceedings of the Thirtieth Tax Conference*, 1978 Conference Report (Toronto: Canadian Tax Foundation, 1980), 52-67, at 59.

[15] See C.W. Primeau, "Surplus Stripping: The Departmental View" (1974), vol. 22, no. 5 *Canadian Tax Journal* 421-29; B.J. Bryson, "Surplus Stripping: The Application of Subsection 247(1) in Light of the 1975 Amendments to the Income Tax Act," in *Report of Proceedings of the Twenty-Seventh Tax Conference*, 1975 Conference Report (Toronto: Canadian Tax Foundation, 1976), 295-303.

Rates began to move apart (especially with the capital gains exemption), and Revenue's attitudes evolved. In general, the view remained that transactions designed to circumvent the specific surplus-stripping rules were fair game for subsection 247(1). Apart from those cases, the main target of the general provision seemed to be situations in which the seller and the purchasing corporation did not deal at arm's length, or but for some shenanigans would not have been dealing at arm's length. In effect, the basic policy was that the extraction of corporate profits as a capital gain should be prevented if the transaction was in some sense managed or structured by the extractor, an extended notion of non-arm's-length dealings. In addition, an interesting example was provided in a 1986 paper that considered the circumstance in which the corporation with accumulated surplus owned liquid assets or marketable securities, or assets about to be become such. If the cash and near cash was in fact used to fund the purchase, and if the seller took an active role in formulating the transaction, subsection 247(1) might apply.[16]

## The General Anti-Avoidance Rule

Enter the GAAR. When the new section 245 was introduced with the 1987 tax reform there was an expectation, fostered by the Department of Finance, that it would entail the repeal of numerous technical anti-avoidance measures. There was indeed some simplification, but the vast purge of additional provisions never happened. On the contrary: the enactment of specific and highly sophisticated measures to prevent (or correct) perceived abuse continued after 1988 essentially unabated, and seems to be accelerating as we write. Nonetheless, one of the anti-avoidance rules that was repealed with the enactment of the GAAR was subsection 247(1). It was felt at the time that the transactions that escaped the specific surplus-stripping rules, and to which subsection 247(1) might have applied, would be adequately dealt with by the new section 245.[17]

A GAAR information circular was issued in 1988.[18] It observed that various provisions of the Act "indicate the circumstances in which amounts received by a shareholder of a corporation from the corporation on a disposition of shares or other property are to be accounted for as a dividend."[19] If a shareholder manages to realize a capital gain on the disposition of property in a transaction intended to subvert those rules, section 245 will be applied.[20] More recently, the department has indicated that surplus-stripping operations of the type that would have been attacked (or

[16] See Michael Hiltz, "Subsection 247(1) and the 1985 Amendments to the Income Tax Act," in *Report of Proceedings of the Thirty-Eighth Tax Conference*, 1986 Conference Report (Toronto: Canadian Tax Foundation, 1987), 7:1-12.

[17] See Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: the department, June 1988), clause 186, relating to section 245.

[18] *Information Circular* 88-2, October 21, 1988.

[19] Ibid., at paragraph 25.

[20] Ibid.

that fit the description of those it said it would have attacked) under subsection 247(1) are subject to challenge under section 84 (resurrection of the *Smythe* argument), the specific surplus-stripping rules in sections 84.1 and 212.1 (usually a non-arm's-length in fact issue), and the general anti-avoidance rule in section 245.[21]

## SURPLUS STRIPPING TODAY: TIME PRESENT

The main question before the house is what will happen when surplus stripping meets the GAAR. A second question, perhaps less important for taxpayers embroiled in the first but of significance to us, is what should happen.

What kinds of surplus strips attract the malevolent attention of the tax collector at any moment in history is a function of the tax rules and rates then in effect. This dictates our choice of examples. An example that illustrates the issue involves a non-resident owner of a Canadian corporation.

### The Facts: Smythe Revisited

Assume that Foreignco owns all the shares of Canco. Foreignco sells those shares for cash to CanBank, an unrelated Canadian company. There are many factual permutations, and these are important in assessing both Revenue Canada's likely reactions and the logic of the system.

First, suppose that Canco has recently disposed of its assets (either a business or investments) so that it holds only cash. Canco's paid-up capital is nominal. If Canco were liquidated, the full distribution would therefore be subject to non-resident withholding tax. Foreignco decides to sell the shares instead. A bilateral tax treaty exempts gains on the sale of shares unless the value is derived from immovable property. Therefore, Foreignco stands to benefit by avoiding withholding tax on the distribution. CanBank is prepared to buy the shares at a slight discount from the cash value.

In the second variation, we assume that Canco still owns a business or investment assets (not real estate). CanBank is willing to purchase the shares at a discount to the market value of the underlying assets, less any tax cost of realization.

1) If the assets are not marketable, Foreignco might agree to buy them back from CanBank (or from Canco, after it is owned by CanBank) at a predetermined price.

2) If Canco has already found, or can find, a third-party purchaser, arrangements could be made in advance for a sale of the assets by Canco to that person after the purchase by CanBank.

3) If the assets are marketable securities, the sale can be accomplished by CanBank after the purchase without any prior arrangements.

[21] This position has been taken in the pleadings filed in at least one court case. See the Crown's reply in *Equilease Corporation v. The Queen*, 94-1753(IT)G (TCC). We are indebted to Alan Schwartz of Fasken Campbell Godfrey for providing us with this material.

CanBank may cause Canco to be liquidated shortly after the acquisition in order to "bump" the cost base of capital property of Canco prior to the sale of such property under paragraph 88(1)(d) of the Act.

## The Analysis

It is convenient to follow the department's three-front assault.

### *Section 84*

The statute still refers to the "winding-up, discontinuance or reorganization" of the business of Canco, as it did in the days of *Smythe*. In that case, there really was (or at least there was certainly a good argument in favour of the view that there was) such an event. The assets of the old company were sold to the new company as part of an integrated and preordained series. Our example has been made purposely ambiguous. What degree of linkage is required between the liquidation of the assets and the sale of the shares?

Our first variation involves a Canco that holds only cash, having already liquidated its assets. Revenue might argue that there is an integrated or composite transaction, and that the property received by Foreignco "really" came from Canco. Obviously, that argument would be strengthened if CanBank immediately liquidated Canco to access its cash. Even if the proceeds of disposition could, with some stretch, be considered "funds or property of Canco," were those funds distributed or appropriated *on* a winding up, discontinuance, or reorganization of the business? While there is no "series of transactions" language in subsection 84(2), a court might be influenced by the degree of interconnectedness of the steps. If Canco's disposal of assets was unrelated to the subsequent realization as a matter of fact, Revenue's argument seems an uphill one.[22]

Our second variation was intended to put the section 84 cat a bit closer to the pigeons. Canco still owns its business. The realization is, admittedly, linked to the surplus-stripping operation. The worst case is where Foreignco buys the assets back from Canco after the shares are sold to CanBank. This is pretty close to *Smythe*, and caution is advised. Canco's selling the property in a prearranged third-party sale is a bit better, but, as so often happens in tax planning, the stronger the commercial protection the higher the tax risk. Where CanBank merely buys a company with marketable securities, the only case for considering the transaction as a surplus strip is the intention of the seller. In such an instance, section 84 seems rather remote.

We conclude that surplus strippers in the 1990s should not forget about *Smythe* and section 84. Yet the old arguments are not without their limitations. If section 84 could have prevented all manner of surplus stripping, we would never have seen either section 212.1 or subsection 247(1).

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[22] Where the transactions are all part of a single series, Revenue may be able to stretch *Smythe* to cover them. They did so in *C. David v. The Queen*, [1975] CTC 197 (FCTD).

***Section 212.1***

The issue is whether Foreignco and CanBank deal at arm's length. Interestingly, that would probably also be the critical issue in determining whether CanBank can successfully bump the cost of any assets on a liquidation of Canco.

We should not lose sight of related traps, such as agency. If CanBank is acting as a mere agent of Foreignco, then Revenue probably need go no further. While banks do not habitually act that way, Foreignco must be careful not to negotiate such a good financial arrangement that agency becomes the only efficient way for CanBank to make a profit.

Even if CanBank is acting on its own account as principal, there are cases in which the arrangements between the parties can suggest a lack of independent bargaining, which is the hallmark of factual non-arm's-length dealings. This is particularly true in the version where Foreignco buys back the assets.

In the other scenes we have painted, the application of section 212.1 is likely to be difficult for Revenue Canada. If CanBank simply buys Canco to get at its assets, it is hard to see why one would conclude that the parties are not dealing at arm's length. Foreignco has no control over CanBank. The price is negotiated between parties with different economic interests.

Overall, section 212.1 seems unlikely to be a very important arrow in Revenue Canada's quiver when the purchaser is someone like CanBank. If the example involved a stripper owned by friends of the shareholders of Foreignco, the analysis would surely be different. Between those extremes lies a range of possibilities with varying degrees of section 212.1 risk.

***Section 245***

The policy issues with which we began these remarks are relevant to the application of sections 84 and 212.1, but they come to the fore when one considers the GAAR. Of course, the application of the GAAR is not only a policy question; there is a statute to contend with, and extensive tax avoidance jurisprudence that may be considered relevant. But policy, under the "misuse or abuse" provision, has a particular role to play.

The conventional section 245 analysis follows these lines:

- Is there a tax benefit?
- Is there an avoidance transaction? That is, why did Foreignco act as it did?
- Is there a misuse or abuse?

If the reduction in tax payable by Foreignco as a result of the surplus-stripping transaction is a "tax benefit" within the meaning of section 245, then there probably is an avoidance transaction. While there may be other good reasons for selling to CanBank, such as avoiding corporate formalities, the tax saving is probably dominant. But is there a "tax benefit"?

"Tax benefit" was a slippery concept when section 245 was enacted, and the traction is not getting any better. A problem often raised by commentators is that of determining which transaction forms the base line. Revenue Canada seems to consider it obvious that in a surplus strip such as this, Foreignco has obtained a tax benefit by realizing a treaty-protected capital gain instead of a dividend, which would have been subjected to non-resident withholding tax. Could one not just as well say that liquidation is a "tax detriment" compared to the available alternative of a tax-free sale?

Tax authorities may regard such reasoning as self-serving sophistry, but that is unfair. In our example, why is it obvious that Foreignco should realize the underlying surplus as dividend rather than gain? The mere fact that there *is* underlying surplus does not mean that distribution is the natural way of realizing its value. Public companies in Canada distribute only a fraction of their earnings as dividends. Assuming that everything gets realized eventually, that means that the rest of those earnings are realized as sales on the stock exchanges. There is nothing particularly unnatural about receiving the economic value of retained earnings by selling shares.

As a matter of statutory construction, it may be argued that the definition of "tax benefit" does not require one to find a normative transaction. Revenue Canada or its lawyers may contend that there is a "reduction of tax" whenever the less expensive course is chosen, then concede that most of those benefits do not bring on the application of the GAAR because they are not tax-motivated or, even if they are, they do not meet the "misuse or abuse" test. This is reminiscent of the (unsuccessful) argument that everything belongs to the Crown, and any reduction in tax payments is a "grant, subsidy or other assistance."[23] Is there a tax "reduction" if an individual decides one morning not to go to work? Even when there are alternative means of achieving the same or a similar economic result, we doubt that choosing the least expensive will always constitute a reduction in tax within the meaning of subsection 245(1). We suspect that the courts will not accept that "reduction" has no starting point.

One should not lose sight of the implications of Foreignco's claim for treaty relief. Tax treaties allocate taxing jurisdiction in an effort to prevent double taxation and tax avoidance. If Foreignco engages in a bona fide transaction that is described in a particular treaty article (gains), and if that article precludes Canadian taxation, one should not lightly conclude that this is a "reduction" in tax compared to some hypothetical norm.

This brings us to the "misuse or abuse" test. The meaning is not self-evident, which may explain why the French translator simply dropped "misuse" and stuck with "abuse." This is not the place to delve into the

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[23] This argument was made in *GTE Sylvania Canada Ltd. v. The Queen*, [1974] CTC 408 (FCTD), affd. [1974] CTC 751 (FCA), although it is only implicitly referred to in the reasons for judgment.

analysis or psychoanalysis of subsection 245(4). Our limited question is whether surplus stripping of the type described in this example is an "abuse" in the statutory context of the taxation of capital gains and corporate distributions.

On its face, this seems a strange allegation. Some sections of the Act tax gains and others tax distributions. It is difficult to understand why it is abusive to fall within one system or the other. It happens every day when shareholders sell their publicly traded shares before or after dividends are paid. The departmental theory, therefore, must involve something more, probably a finding that the "conversion" of dividends to gains is contrived or artificial, and that the intent of the distribution taxation provisions of the Act has not been met.[24]

This brings us full circle. The "misuse or abuse" test, or the "object and spirit" test, poses anew our earlier question: why are dividends and gains taxed as they are? And what is the implication of the treaty relief? Judges will have to make sense of section 245, and will probably follow their noses, ferreting out schemes that are fiscally malodorous. In this surplus-stripping example, at least under most permutations, we do not find the smell overpowering. Our reading of the policy is that corporate earnings need not be taxed more than once, since tax-free sale is permitted and openly negotiated in bilateral tax treaties. We are not sure where the withholding tax on dividends fits in. It is an odd policy that imposes a higher tax on distributed earnings than on gains, even where those gains represent accumulated earnings. Yet that is what we (and many other countries) have. While the facts are obviously paramount, as a general rule we do not see any abuse in organizing one's affairs so as to fall within the gains as opposed to the distribution regime, or vice versa.

## TIME FUTURE

Ideally, corporate income taxation would serve merely to withhold tax on account of the liability of the shareholder. There would be perfect integration, applied to both dividends and gains, domestically and internationally. Surplus stripping would be as impossible as it would be unnecessary.

That ideal will not be realized. One reason is that governments like to tax foreigners. Europe has abolished internal dividend withholding, and the globalization of capital seems to militate in favour of the zero rate.[25] But this is far off for Canada. Domestically, the same pressures will build if (when) rate movements again make stripping attractive to individuals.

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[24] We do not wish to date our remarks with references to recent cases, particularly tribunal judgments under appeal. It is, however, interesting that the first judicial GAAR skirmish was resolved, at the International Trade Tribunal, in favour of the Crown with language such as this. See *Michelin Tires (Canada) Ltd. v. MNR*, [1995] GSTC 17 (CITT).

[25] As non-economists, we repeat the popular slogan, but it is not clear that all the evidence is in. There are those who argue that national savings rates still strongly correlate with national investment rates, and that internal borrowing continues to outpace real international debt flows.

Even if the financial incentive to strip dividends remains constrained by better integration domestically and lower dividend withholding internationally, international enterprises and private capital pools will become ever more creative at exploiting ever finer arbitrage and tax-planning opportunities. Highly sophisticated financial and tax planning will also incite taxpayers to jump through more hoops for marginal savings. The end of tax-reduced extraction of corporate surplus is not nigh.

This ought not to demoralize the fisc. With proper and workable anti-avoidance legislation, intelligent and vigilant courts, and well-trained tax inspectors, the integrity of the substantive tax system can be protected. In such an environment, what may appear to be aggressive tax planning is merely the market for ideas applied to enhance fiscal efficiency. This is not intended as witticism or cynicism. That market has created the wealth, both material and spiritual, which we enjoy as no people before us ever did. It should not lightly be discarded, even in matters fiscal. The ingenuity of taxpayers, admittedly prompted by a selfish Darwinian desire to save money, will not destroy the tax system any more than the profit motive destroys commerce. It will, on the contrary, actualize the real substance of that system. Of course, if the system is illogical, poorly thought out, and full of economic wedges and contradictory policies, taxpayers' behaviour will look the same. If domestic law and tax treaties permit tax-free realization of corporate surplus by sale, and tax the same realization if it is characterized as a dividend, strippers will abound.

We hope that Revenue will become ever more careful and cautious, the law more cohesive and consistent, and courts more cogent and comprehending of fiscal policy. We expect that we will see a bit of that, and a lot of activity on the part of those participants in the tax system who are regulated by the market rather than by regulation—namely, the taxpayers.

We wish them well.