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A-298-07
A-299-07
A-300-07

Citation: 2008 FCA 398

CORAM: **NOËL J.A.**
NADON J.A.
TRUDEL J.A.

BETWEEN:

A-297-07

2529-1915 QUÉBEC INC.

Appellant

and

HER MAJESTY THE QUEEN

Respondent

- -

A-298-07

2530-1284 QUÉBEC INC.

Appellant

and

HER MAJESTY THE QUEEN

Respondent

- -

A-299-07

ROBERT LANGLOIS

Appellant

and

HER MAJESTY THE QUEEN

Respondent

- -

A-300-07

RALPH E. FARAGGI

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Hearing held at Montréal, Quebec, on October 22, 2008.

Judgment delivered at Ottawa, Ontario, on December 12, 2008.

REASONS FOR JUDGMENT BY: NOËL J.A.

CONCURRED IN BY: NADON J.A.
TRUDEL J.A.

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REASONS FOR JUDGMENT

NOËL J.A.

[1] These are four appeals from decisions of Rip A.C.J.T.C., as he then was ("TCC judge"), confirming, further to a common hearing and based on a single set of reasons, the assessments made by the Minister of National Revenue ("Minister") under the *Income Tax Act*, R.S.C. 1985, c. 1, (5th Supp.) ("Act"), with penalties against each of the appellants.

[2] The issue arises from a very elaborate tax plan devised and implemented in 1987 by the appellants Langlois (tax specialist) and Faraggi (corporate law specialist) while they were members of the firm Stikeman Elliott in Montréal ("Langlois and Faraggi" or "the devisers"). The appellants 2529-1915 Québec Inc. and 2530-1284 Québec Inc. are companies that were incorporated by the devisers and played a key role in the implementation of their plan ("1915 Inc." and "1284 Inc." or "the corporate appellants").

[3] The four appeals before this Court, as those before the TCC, were heard together. Langlois and Faraggi raised the same arguments in support of their respective appeals, and the corporate appellants did likewise. These reasons deal with and dispose of the four appeals and will be filed as reasons for judgment in each of the Court files.

THE FACTS

[4] The objective of Langlois and Faraggi's plan was to produce capital gains in the hands of a series of corporations in order to create capital dividend accounts ("CDA" or "CDAs") and to transfer, subject to the payment of a monetary consideration, the tax benefit inherent in these CDAs to unrelated companies in a position to use them ("third-party corporations"). At the end of the exercise, Langlois and Faraggi together had pocketed the sum of $12,345,255 (detailed calculations of this amount are set out in Appendix 3 of the judgment under appeal).

[5] The plan was implemented in two phases involving approximately thirty companies incorporated for that purpose. Langlois and Faraggi were the directors and had control of these companies. The first series of transactions began on August 13, 1987, and the second, carried out in two phases, began on September 9, 1987. The transactions are complex. They are described in detail in the Statement of Facts filed by the appellants in the Tax Court of Canada (Appeal Book (A-300-07), Volume II, pages 200 to 336), and summarized by the TCC judge at paragraphs 11 to 17 (first series of transactions), and 19 and 20 (second series of transactions) of his reasons.

[6] Without departing from the TCC judge's summary save to make two clarifications in the course of the analysis, I propose to focus only on the aspects of the plan that are essential to the disposition of the appeals.

[7] The first series of transactions was funded by a loan akin to a one-day advance (described in the evidence as a "daylight overdraft") of $10,000,100 by the Royal Bank for a period of time during the day on August 13, 1987. The loan was made to 2258-5644 Québec Inc., a company incorporated by Langlois and Faraggi ("2258 Inc." or "the first subsidiary"). The second series was funded by Langlois and Faraggi using the money they had made during the first series of transactions. In total, the first series of transactions yielded gains of $109,998,900, thus constituting a cumulative CDA of $54,999,450. The second series generated gains of $123,688,763 in two phases ($58,899,411 in the first phase and $64,789,352 in the second), resulting in a cumulative CDA of $61,844,381. These CDAs, up to $82,712,000, were eventually transferred to third-party corporations.

[8] Before going further, a few words on the operation of CDAs are in order. A CDA is composed of the non-taxable portion of a capital gain generated by a corporation (i.e., half of the gain realized during the period at issue). The legislative objective is to ensure that a capital gain is taxed in the same manner, whether it is earned directly by an individual or indirectly through a corporation. To this end, the system provides that, subject to the prescribed elections being made, the non-taxable portion of a capital gain, once included in a CDA by the corporation that realized it, remains tax-exempt when transferred from one corporation to another by way of dividend, until it is ultimately distributed to an individual in the form of a non-taxable dividend, also called a "capital dividend".

[9] Since not everyone has access to the benefit provided by a CDA (for example, non-resident shareholders could not receive tax-free dividends), this system, which dates back to the 1970s, gradually gave rise to corporations that were rich in CDAs that, however, could not be used by the corporations' shareholders. As a result, planning techniques allowing these CDAs to be transferred to corporations owned by shareholders able to make use of them were developed. These are the techniques that inspired the plan conceived by the devisers (Robert Langlois's testimony, Appeal Book (A-300-07), Volume VIII, pages 61 to 63 (1518 to 1520)).

[10] Contrary to what was being done at the time, the arrangement put in place by the devisers was not based on an existing source of CDAs. It included an additional phase allowing for the generation of capital gains and the creation of CDAs. The method used in the first series of transactions shows how the devisers of the plan went about generating these gains and transferring

the resulting CDAs to third-party corporations. The TCC judge based his analysis on this first series, and I propose to do the same since the appellants did not take issue with the approach used by the TCC judge in this regard.

[11] A series of 13 corporations ("A Inc." to "M Inc." in the TCC judge's summary) was first created, each holding the totality of the common shares of the corporation immediately following it in a vertical line. The loan made by the Royal Bank to the first subsidiary was deposited in its account (opened at the same bank) and used to issue a certified cheque in the amount of $10,000,000 to pay for a block of 10,000 preferred shares issued by the second subsidiary; the second subsidiary then used the $10,000,000 thus received to issue a certified cheque in this same amount and acquire an identical block of shares issued by the third subsidiary, which then acquired the preferred shares issued by the fourth, and so on, until the twelfth subsidiary had acquired the preferred shares issued by the thirteenth.

[12] The second subsidiary after having issued the preferred shares and after these were subscribed to by the first subsidiary, declared a stock dividend of 10,000 shares. The shares thus issued had a very high redemption value (i.e., $10,000,000) and a very low paid-up capital (i.e., $0.01 per share or $100 in total). The third subsidiary declared an identical stock dividend in favour of the second subsidiary as the holder of its preferred shares, and so on, until the twelfth subsidiary, so that at the end of this part of the transactions, twelve of the thirteen subsidiaries in the chain were holders of special class shares with a very low tax cost (i.e., adjusted cost base ("ACB")) and a very

high redemption value (“gain-making shares”). The gain-making shares are identified as the Class “K” shares in the TCC judge’s summary.

[13] The second subsidiary subsequently sold the gain-making shares to the first subsidiary for a value equal to their redemption value: $10,000,000. This debt was evidenced by a promissory note payable on demand. Given that the gain-making shares had a tax cost of $100 ($0.01 x 10,000), the subsidiary thus realized a capital gain of $9,999,900. Each of the other subsidiaries in the chain (except for the thirteenth) sold the gain-making shares to the first subsidiary in the same manner, thereby generating on paper cumulative gains of $109,998,900.

[14] To enable the first subsidiary to reimburse the $10,000,100 bank loan, the thirteenth subsidiary declared a cash dividend of a corresponding amount in its favour, paid by certified cheque at the end of the exercise on August 13. The first subsidiary used this amount to reimburse the bank.

[15] Further to the sale of the gain-making shares, eleven of the subsidiaries (the second to the twelfth inclusively) had a purported CDA equal to half of the gain thus realized, totalling $54,999,450 (Reasons, paragraph 16 (f)). At this point, these eleven subsidiaries amended the par value of the gain-making shares, all held at that time by the first subsidiary, so as to increase the par value from $0.01 to $500. In doing so, they triggered deemed dividends in the amount of $54,998,900 in the hands of the first subsidiary, pursuant to subsection 84(1) of the Act. This provision provides that when a corporation increases the paid-up capital of its shares, a dividend

equal to the increase shall be deemed to have been received by the shareholder, that is, in this case, $500 x 10,000 shares = $55,000,000 less the ACB of the gain-making shares, i.e., $1,100 (Reasons, paragraph 16 (h)).

[16] In respect of this deemed dividend, each of the subsidiaries, from the second to the twelfth, made the election provided for in subsection 83(2) of the Act, according to which the dividend

(*a*) … shall be deemed to be a capital dividend to the extent of the corporation's capital dividend account immediately before the particular time; and	*a*) […] est réputé être un dividende en capital jusqu'à concurrence du montant du compte de dividendes en capital de la corporation immédiatement avant le moment donné; et
(*b*) no part of the dividend shall be included in computing the income of any shareholder of the corporation.	*b*) aucune partie du dividende ne doit être incluse dans le calcul du revenu de tout actionnaire de la corporation.

[17] In accordance with the requirements of subparagraph 89(1)(*b*)(ii) of the Act, the first subsidiary included the deemed dividend in its CDA. Under this provision, when computing its CDA, a private corporation must include amounts received

(ii) … in respect of a dividend … on a share of the capital stock of another corporation in the period, which amount was, by virtue of subsection 83(2), not included in	(ii) […],à titre de dividende versé sur une action du capital-actions d'une autre corporation, somme qui, en vertu du paragraphe 83(2), n'a pas été incluse dans le calcul du revenu de la

computing the income of the corporation,	corporation.

[18] Thus, as a result of the elections made by the eleven subsidiaries, the cumulative CDAs of $54,998,900 were transferred to the first subsidiary (Reasons, paragraph 16 (i)). On or about August 21, 1987, the appellant 1915 Inc. subscribed to a block of preferred shares issued by the first subsidiary for $55,023,216 (Reasons, paragraph 16 (k)). Immediately afterwards, the first subsidiary declared a dividend of $49,566,000 to be paid to 1915 Inc., as the owner of the preferred shares (Reasons, paragraph 16 (l)), and made the subsection 83(2) election to indicate that the dividend was paid out of its CDA. At this point, the bulk of the CDAs generated by the subsidiaries was in the hands of 1915 Inc., ready to be transferred to the third-party corporations.

[19] Later, on September 14, 1987, the devisers arranged for the subsidiaries that had generated gains to sustain losses equal to the gains (i.e., $110,000,000); they did so by selling the preferred shares acquired at $10,000,000 to Faraggi for $100.

[20] At various times between September 2 and 22, 1987, 1915 Inc. transferred the CDAs to third-party corporations. These third-party corporations were owned by shareholders wishing to receive, tax-free, accumulated surpluses which otherwise could only be distributed on a taxable basis. They had been approached by the devisers over the preceding months.

[21] The transfer of 1915 Inc.'s CDA to the third-party corporations took place in two stages. First, each of the third-party corporations subscribed to different classes of preferred shares of 1915 Inc. These shares all had a minimal par value – for example, $0.01 – and a high redemption value – for example, $1,000. After the subscription, 1915 Inc. paid a cash dividend of $999.99, thus reducing the redemption value to $0.01, while at the same time making the election set out in subsection 83(2), according to which the dividend was deemed to have come from its CDA. (At the hearing, counsel for the corporate appellants explained that, contrary to what the TCC judge said in his reasons (Reasons, paragraph 16 (n)(i) and paragraph 3), the dividend in question was not a deemed dividend, but rather a cash dividend. Nothing flows from this error). The third-party corporations thereby saw their own CDAs increase accordingly by virtue of subparagraph 89(1)(*b*)(ii) of the Act (see paragraph 17 above). In the last stage of the plan, 1915 Inc. would redeem the preferred shares at their reduced redemption value of $0.01.

[22] Importantly, the plan contemplated that the third-party corporations would pay a premium when subscribing to the preferred shares of 1915 Inc. For example, if the redemption value was $1,000, the third-party corporation was to pay $1,210 per share. It is this premium of $210 per share that enabled the two corporate appellants to accumulate surpluses ($8,105,344 in the case of 1915 Inc. and $4,677,717 in the case of 1284 Inc.) after having paid the cash dividends and redeemed the shares (see Appendices 1 and 2 to the judgment under appeal, setting out the computation of the surpluses generated by the corporate appellants).

[23] By proceeding in the same manner as the third-party corporations (save for the payment of the premium on the preferred shares), the devisers became shareholders and were paid dividends by 1915 Inc. (and three other corporations that they had incorporated). The dividends so paid amounted to $6,085,762 in the case of Langlois and $6,025,624 in the case of Faraggi. In December of the following year, they were paid another dividend in the amount of $116,934 ($233,868 in total). The corporations that paid these dividends made the subsection 83(2) election so that the dividends received by the devisers were also deemed to be capital dividends.

[24] It is important to note that, at the implementation stage of the plan, the devisers obtained an opinion (in short and long form) confirming the legal effects of their plan for the benefit of their clients (the opinions are reproduced as Appendices 5 and 6 to the judgment under appeal). These opinions are signed by Mr. Maurice Régnier, a noted practitioner who was at the time a senior partner in the Stikeman Elliott firm.

[25] Mr. Régnier testified before the TCC judge and was questioned regarding the scope of this opinion. The minutes of a meeting held on May 12, 1989, between Mr. Régnier and Revenue officials show that he did not concern himself with the source of the CDAs (Reasons, paragraph 51):

> The CDA source was never questioned by Mr. Régnier as to its source; it was presumed to arise from real and legitimate transactions giving rise to increases to the CDA accounts; to the extent of any inaccuracies as to the quantum, the Income Tax Act provided for a Part III tax to the transferor but a full increase in the CDA account of the transferee. Mr. Régnier never thought of, to say the least, the possibility of a fabrication.

> Mr. Régnier did not question the significant quantum of CDA referred to in the September 2/87 long opinion given to Mr. Langlois - approximately $49.6 million. In his mind, he believed that Mr. Langlois had “found” a source similar in scope to SNC, and also remembered Mr. Langlois's reference to banking arrangements and an acquaintance at Dominion Securities. [Citation omitted.]
>
> Mr. Régnier would be on a trip for two weeks during September /87; during his absence Mr. Langlois would 'close' his CDA deals.
>
> Mr. Régnier never participated at any closings.

The TCC judge accepted Mr. Régnier’s testimony that he had opined on the provisions relied upon by the devisers to implement their plan, without expressing any view on the source of the CDAs, since this was not part of his mandate (Reasons, paragraph 52). The TCC judge’s assessment of Mr. Régnier’s evidence is not questioned in these appeals.

[26] Relying on this opinion, Langlois and Faraggi treated the dividends that they received as having been paid on a tax-free basis. Their 1987 and 1988 income tax returns do not reflect any inclusion on that account.

[27] Similarly, in their 1987 tax return, the two corporate appellants did not account for the surpluses that they generated. According to the corporate appellants, the fact that these surpluses arose from a premium that was part of the price paid by the third-party corporations to subscribe to shares meant that they were capital contributions, and therefore tax-free.

The assessments

[28] By assessments issued August 16, 1995, the Minister added the surpluses generated during the corporate appellants' 1987 taxation year in the computation of their income for that year (i.e., $8,105,344 in the case of 1915 Inc. and $4,677,717 in the case of 1284 Inc.), with penalties. According to the Minister, these surpluses constituted business income in the hands of the corporate appellants which they had knowingly, or under circumstances amounting to gross negligence, failed to include in computing their income for that year.

[29] The Minister also added to Langlois's and Faraggi's income the dividends received during their 1987 and 1988 taxation years, grossed up by one third (the total dividend so assessed was $8,114,350 in 1987 and $155,912 in 1988 in Langlois's case, and $8,034,166 in 1987 and $155,912 in 1988 in Faraggi's case). Penalties were also assessed.

[30] According to the Minister, the sale by the subsidiaries of the gain-making shares, despite all appearances, did not give rise to capital gains. In this respect, the transactions were shams. It follows that the subsidiaries had no CDAs and could not pay capital dividends to the corporate appellants. The corporate appellants could not in turn pay dividends out of their CDAs to the devisers, since they had no CDAs.

[31] The appellants objected to the assessments, which were eventually confirmed by the TCC judge's decision dismissing the four appeals.

TCC DECISION

[32] The TCC judge began his analysis by quoting the expanded definition of the word "business" in subsection 248(1) of the Act. He then stated the following (para. 79):

> It is not any kind of activity or undertaking that may be considered a business; there must be some commercial quality to the activity or undertaking for it to qualify as a business. The "blueprint" for the eventual "transfer" of CDA to third parties and for the payment of dividends to the individual appellants, the solicitation, directly or indirectly, of persons who could benefit from the "transfer" of CDA and other actions by the appellants were all in the nature of a commercial enterprise, no different from the development of a product, the manufacture of that product and the sale of that product by a person carrying on a business. . . .

[33] He continued as follows (*idem*):

> . . . That the intent of the parties was cloaked in purported agreements, in the issuance of shares, in the declaration of dividends and deemed dividends, in capital gains and in subsection 83(2) elections does not change what the appellants intended and what they actually did. The corporate appellants carried on a business of creating dividends, which they advertised as dividends from their capital dividend accounts, and these accounts, if nothing else, they transferred in reality to third parties for a profit. The profits, or parts thereof, were then distributed to the individual appellants as dividends that are to be included in the incomes of the individual appellants as assessed. These dividends were not paid out of any corporation's CDA. There was no amount that was eligible for election under subsection 83(2) of the *Act*.

[34] The TCC judge then cited the definition of the term "sham" as set out by Lord Diplock in *Snook v. London & West Riding Investments, Ltd.,* [1967] 1 All E.R. 518 at page 528, and certain other Supreme Court decisions that have given effect to the concept of "sham" in Canadian law. [The Minister in his assessments and the TCC judge in his decision used the expression

"trompe-l'œil" in French to express the concept of "sham". The words "artifice", "faux-semblant", "simulacre" and "frime" are also used in Canadian case law. In my opinion, the word "frime" is most appropriate, considering its primary meaning, which denotes a conduct that is "volontairement trompeur . . . en apparence seulement (cf. Pour la galerie)" ["intentionally deceitful . . . in appearance only (see for appearances' sake)"], *Le Nouveau Petit Robert*, new edition, at page 974. Moreover, this word was used by the Supreme Court in its first decision dealing with the concept of "sham", as set out in *Snook, supra* (*Minister of National Revenue v. Cameron*, [1974] S.C.R. 1062). The French word "frime" is henceforth used to express the notion of "sham".] After completing this review, the TCC judge concluded as follows (paragraph 86):

> For a sham to exist, the taxpayers must have acted in such a way as to deceive the tax authority as to their real legal relationships. The taxpayer creates an appearance that does not conform to the reality of the situation.

[35] The TCC judge then referred to the decision of the Supreme Court in *Canada v. Antosko*, [1994] 2 S.C.R. 312, in particular to Iacobucci J.'s statement that (page 328)

> . . . In the absence of evidence that the transaction was a sham or an abuse of the provisions of the Act, it is not the role of the court to determine whether the transaction in question is one which renders the taxpayer deserving of a deduction . . . .
>
> [My emphasis.]

According to the TCC judge, this passage would indicate that "sham" and "abuse of the provisions of the Act" are similar concepts (Reasons, paragraph 87, note 34).

[36] The TCC judge then made the following finding (paragraph 87):

> In the appeals at bar, the essential components of the transactions entered into by the appellants possess the basic elements of sham. There was an abuse of the provisions of the *Act*. The initial purported loan of $10,000,100, the declaration of stock and ordinary dividends, the corresponding exchange of promissory notes and the capital gains and losses cloaked an exercise undertaken by the appellants in concert to gain income from a series of paper transactions. [Citation omitted.]

[37] In addition to this finding, which seems to be directed against the plan as a whole, the TCC judge concluded that the loan granted by the Royal Bank was a sham (Reasons, paragraph 90). According to the TCC judge, the loan in question was a loan for consumption and, at the time, the *Civil Code of Lower Canada* provided that the borrower became owner of the thing lent (Reasons, paragraphs 88 and 89). According to his analysis, the borrowers did not have "the absolute enjoyment" of the loaned funds (Reasons, paragraph 90). As well, no interest was paid (*idem*).

[38] The TCC judge also concluded that the promissory notes, issued by the first subsidiary in the course of the first series of transactions to acquire the gain-making shares from the eleven other subsidiaries, were shams. According to him, those promissory notes did not create any real obligations because they were never meant to be honoured. Only the nominal sum of $100 was available to the first subsidiary to fund the payment. The TCC judge concluded from this that the eleven subsidiaries had no intention of collecting on the notes (Reasons, paragraphs 91 and 92).

[39] With respect to the penalties, the TCC judge found the following (Reasons, paragraph 96):

> . . . The appellants knowingly carried out and promoted a series of transactions they knew were artificial and were an abuse of provisions of the Act. Yet they prepared and filed the tax returns in issue, or caused these tax returns to be prepared, knowing full well that the information contained in the returns for 1987 for all the appellants and the returns for 1988 for the individual appellants contained false statements or omissions. The corporate appellants knew that they were carrying on a business and their profits were camouflaged as dividends out of CDAs. And the individual appellants knew the dividends they received from the corporate appellants were taxable dividends. . . .

ALLEGED ERRORS IN THE DECISION UNDER APPEAL

[40] The four appellants allege that the TCC judge relied on non-existent rules to support his finding as to the existence of a sham. They submit that, at the time when the transactions at issue took place, neither the General Anti-Avoidance Rule (GAAR) nor the rule now provided for in subsection 83(2.1) of the Act was in force (this last provision, which the appellants say was enacted in reaction to their plan, provides that as of September 25, 1987, a dividend subject to the election provided for in subsection 83(2) is not a capital dividend if its payment is part of a series of transactions having the purpose of receiving a capital dividend).

[41] In their respective memoranda, the appellants all refer to the following excerpts from the decision under appeal to show that the TCC judge was guided by the GAAR and the concept of "abuse":

> [80] . . . The manner in which they wished to achieve their goal was not consistent with the object, spirit or purpose of, for example, section 89, subsections 52(3), 83(2) and 84(1) of the Act.
>
> . . .

> [87] In the appeals at bar, the essential components of the transactions entered into by the appellants possess the basic elements of sham. There was an abuse of the provisions of the *Act*. The initial purported loan of $10,000,100, the declaration of stock and ordinary dividends, the corresponding exchange of promissory notes and the capital gains and losses cloaked an exercise undertaken by the appellants in concert to gain income from a series of paper transactions.
>
> . . .
>
> [93] . . . Finally, it is clear that specific provisions of the *Act* were abused contrary to their object and spirit.
>
> [Emphasis by the appellants.]

[42] The appellants contend that the evidence does not allow for the conclusion that there was a sham based on the recognized application of this doctrine. They point out that the legal documentation reflects the parties' true intentions and the true effects of the transactions carried out between them. The share subscriptions took place, actual dividends were paid out, elections were made, the amounts that had to be paid were paid and the documentation reveals exactly what occurred. The parties to the transactions had no intention whatsoever of giving the appearance of a "sham transaction" to cover up a "real transaction" (*Snook*, *supra*, page 545).

[43] According to the appellants, the TCC judge's analysis as a whole was flawed by his GAAR-based approach and the application of obsolete rules such as "economic reality", thus extending the concept of "sham" beyond that which was applicable in 1987, when the transactions took place. In this regard, they cite several articles published in various tax journals that sharply criticize the TCC judge's decision and in particular his application of the sham doctrine (Timothé Huot, "Sham – As Bad As It Gets," *Tax Topics*, Toronto: CCH, Number 1857, October 11, 2007; Thomas E.

McDonnel, "CDA Tax Scheme Voided – Sham Doctrine Expanded?" *Tax for the Owner-Manager*, Canadian Tax Foundation, Volume 7, Number 4, October 2007; Laura Stoddard, "Stretching the Sham Doctrine?" *Canadian Tax Journal* (2007), Volume 55, Number 4, pages 850-853).

[44] As for the specific finding that the daylight loan was a sham, the appellants contend that the cashed certified cheques undoubtedly amounted to a valid payment. According to the appellants, the TCC judge erred in finding that the bank overdraft granted by the Royal Bank was a sham.

[45] The appellants add that, contrary to the TCC judge's finding, none of the promissory notes were cancelled without consideration. The promissory notes were cancelled either following payment by cheque or, wherever two parties held debts of equivalent amounts against one another, by way of compensation. They add that, contrary to what the TCC judge appears to understand, the promissory notes were not intended to serve as a means of payment.

[46] The appellants raise the alternative argument that even if there was a sham so that no capital gain was realized, the assessments are nonetheless invalid. In this respect, the corporate appellants and the devisers advance different arguments.

[47] The appellant corporations submit for their part that, capital gain or not, the Minister could not treat the premium paid by the third-party corporations when subscribing to the shares as business income. According to the appellant corporations, it is well established that share subscriptions are not commercial transactions, no matter the goal sought by the corporation in

issuing the shares. (The decisions of the Supreme Court in *Irrigation Industries Ltd. v. The Minister of National Revenue*, [1962] S.C.R. 346 (paragraph 21); of the TCC in *Molstad Development Co. Ltd. v. Her Majesty the Queen*, 97 D.T.C. 913; and of this Court in *Queenswood Land Associated Ltd. v. Her Majesty the Queen*, 2000 D.T.C. 6065 (paragraph 30) are cited in support of this proposition.) The appellant corporations add that within [TRANSLATION] "well-accepted business principles" and [TRANSLATION] "generally accepted accounting principles" there is no rule that suggests or allows for the proposition that a corporation can make a [TRANSLATION] "profit" from a sum received as a result of a share subscription.

[48] On the other hand, Langlois and Faraggi emphasize the fact that Parliament has, under Part III of the Act, specifically provided for the case of a corporation declaring a dividend when the amount in its CDA is not sufficient to cover the amount of the dividend. In those circumstances, subsection 184(2) provides that the corporation shall pay a special tax equal to three quarters of the shortfall, in which case the excessive dividend remains tax-free in the hands of the shareholders. According to Langlois and Faraggi, the facts at issue in this case dictate that Part III should have been applied.

[49] Langlois and Faraggi also argue that subsection 83(2) is a mandatory provision according to which a dividend is "deemed to be a capital dividend". According to the devisers, this provision has the effect of treating the deemed dividend received by the first subsidiary as a capital dividend, regardless of whether the subsidiaries that paid this dividend generated capital gains.

[50] In the same vein, subparagraph 89(1)(*b*)(ii) provides that a corporation that receives a dividend further to an election made under subsection 83(2) “shall” include the amount thus received in its CDA. It follows that even if the subsidiaries had no CDAs to begin with, the first subsidiary had to include the dividends received in its CDA. The same reasoning applies to the subsequent dividends until the ultimate distribution.

[51] Lastly, Langlois and Faraggi insist on the fact that the subsidiaries, which generated capital gains giving rise to CDAs, were never reassessed. In the absence of assessments nullifying the gains duly declared by the subsidiaries, the Minister was required to respect the tax implications resulting from the elections made by the subsidiaries.

Position of the respondent

[52] Counsel for the respondent asks that the four appeals be dismissed. He relies entirely on the reasons given by the TCC judge.

ANALYSIS AND DECISION

[53] In their respective memoranda, the parties did not address the standard of review. Counsel acknowledged during the hearing that questions of law are subject to the standard of correctness, while questions of fact and of mixed fact and law may not be reviewed in the absence of palpable error (*Housen v. Nikolaisen*, [2002] 2 S.R.C. 235).

The concept of "sham" in Canadian law

[54] The main attack directed against the decision of the TCC judge is that he unduly stretched the concept of "sham". In that respect, the appellants are correct in saying that the state of the law in 1987 did not allow the TCC judge to ignore the transactions or disregard their effects on the sole ground that they give rise to an abuse. Only the advent of the GAAR and its invocation in a particular case allow the Minister to repudiate a transaction on the sole ground that it gives rise to an abuse of the Act or some of its provisions.

[55] The concepts of "sham" and "abuse" are not the same. I do not believe that the few words of Iacobucci J. in *Antosko*, *supra*, cited by the TCC judge (Reasons, para. 87, note 34), were intended to alter this view. Nowhere in the extensive case law dealing with the concept of "sham" is it suggested that "sham" and "abuse" are analogous. Iacobucci J.'s brief comment, which was part of a discussion on the principles of statutory interpretation, cannot be read as bringing about such a radical change.

[56] Subject to the invocation of the GAAR in a particular case, taxpayers are entitled to arrange their affairs in such a way as to minimize their tax burden, even if in doing so, they resort to elaborate plans that give rise to results which Parliament did not anticipate. This is, I think, what the Supreme Court pointed out in *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, when it said the following (paragraph 45):

> However, this Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. This issue was specifically addressed by this Court in *Duha Printers (Western) Ltd. v. Canada*, [1998] 1 S.C.R. 795, at para. 88, per Iacobucci J. See also *Neuman v. M.N.R.*, 1998] 1 S.C.R. 770, at para. 63, *per* Iacobucci J. The courts' role is to interpret and apply the Act as it was adopted by Parliament. *Obiter* statements in earlier cases that might be said to support a broader and less certain interpretive principle have therefore been overtaken by our developing tax jurisprudence. Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.

[57] However, courts have always felt authorized to intervene when confronted with what can properly be labelled as a sham. The classic definition of "sham" is that formulated by Lord Diplock in *Snook*, *supra*, and reiterated by the Supreme Court on a number of occasions since. In *Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536, Estey J. said the following (page 545):

> . . . This expression comes to us from decisions in the United Kingdom, and it has been generally taken to mean (but not without ambiguity) a transaction conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away from the taxpayer or the true nature of the transaction; or, simple deception whereby the taxpayer creates a facade of reality quite different from the disguised reality.

This passage is also quoted with approval in *Continental Bank Leasing Corp. v. Canada*, [1998] 2 S.C.R. 298, at paragraph 20.

[58] In *Cameron*, *supra*, the Supreme Court adopted the following passage from *Snook*, *supra*, to define "sham" in Canadian law (page 1068):

> . . . [I]t means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create.

The same excerpt was quoted by Estey J. in *Stubart*, *supra*, at page 572.

[59] It follows from the above definitions that the existence of a sham under Canadian law requires an element of deceit which generally manifests itself by a misrepresentation by the parties of the actual transaction taking place between them. When confronted with this situation, courts will consider the real transaction and disregard the one that was represented as being the real one.

Corporate appellants

[60] The question in issue, insofar as the corporate appellants are concerned, is limited to whether the premiums which they extracted from the third-party corporations as part of the subscription share price can properly be included in their income. I do not believe that it was necessary to resort to the concept of “sham” to dispose of this issue.

[61] The gist of the TCC judge’s reasoning in confirming the assessments issued against the corporate appellants can be found at paragraph 69 of his reasons:

> . . . What the corporate appellants did was to enter into a business, at minimum a venture in the nature of trade, and the difference between what the arm's length third party corporations paid for preferred shares and the amounts for which the shares were redeemed was business income to the corporate appellants. . . .

[62] The existence of a business under the Act is not subject to any formal requirements (reference is made to the extensive definition of the word "business" in subsection 248(1) of the Act). The sole prerequisite is the pursuit of profit (see Vern Krishna, *The Fundamentals of Canadian Income Tax*, 8th ed., page 273). In this case, under the devisers' plan, the third-party corporations were required to pay the corporate appellants a surcharge for the shares which they subscribed to in order to have access to the CDAs. The third-party corporations were required to pay $1,210 per share even though it was understood that the shares would be redeemed for $1,000 (Reasons, paragraph 3). The difference between the share redemption value and the price paid by the third-party corporations is described as a [TRANSLATION] "premium" in the legal opinion obtained by Langlois and Faraggi when they were implementing their plan. The word "premium" is here used in its commercial sense rather than its corporate sense to refer to the additional negotiated amount over the subscription price.

[63] The premiums paid by third-party corporations allowed the corporate appellants to accumulate surpluses of $8,105,344 and $4,677,717 respectively. In my view, the fact that these premiums were added to the share subscription price instead of being charged separately has no effect on the TCC judge's finding of fact that these premiums were amounts paid by the third-party corporations to the corporate appellants for access to their CDAs.The TCC judge's finding on this point is strictly based on the application of the Act to the facts found in the course of his analysis.

[64] In this respect, the evidence shows unequivocally that it was agreed at the time of subscription that the shares had a redemption value of $1,000 and that they would be redeemed at

the price of $0.01, following the payment of a cash dividend of $999.99. It follows that according to the plan implemented by the devisers, $1,000 was the maximum value the preferred shares could have had at any time in the hands of the third-party corporations. The premium was therefore paid for something other than the shares. This was obviously access to the CDAs and in particular the corporate appellants' undertaking to make the required elections pursuant to subsection 83(2) in order to give the third-party corporations access to their CDAs (in this regard, see paragraph 3 of the legal opinion obtained by the devisers (short form)). This is not seriously being called into question, as even the documents used by the devisers to market their plan describe the premium as "the price of the CDA" (Appeal Book (A-300-07), Volume V, page 1020).

[65] The alternative argument that a share subscription must always be treated on account of capital regardless of the circumstances is without merit. The case law cited by the corporate appellants in that regard (paragraph 47, *supra*) does not have the effect attributed to it. Under the Act, no transaction or operation is systematically excluded from the concept of business. The question whether a given operation amounts to a business must be determined in accordance with the particular facts of each case.

[66] In the present case, as additional amounts collected by the corporate appellants were generated in the course of successive operations the purpose of which was to produce surpluses, all the factors underlying the existence of a business are present. In my opinion, the TCC judge correctly concluded that the corporate appellants were engaged in a business and that these additional amounts constituted business income.

Langlois and Faraggi

[67] The bulk of the dividends received by the devisers was paid during the implementation stage of the plan, as and when dividends were paid to the third-party corporations. It follows, according to Langlois and Faraggi, that like the dividends paid to the third-party corporations those that they received were paid out of a CDA and were, to that extent, capital dividends. However, the TCC judge concluded that the operations leading to the payment of the dividends were a sham. He noted that, contrary to what was represented, no capital gains were generated and no CDAs were created, with the result that the dividends received by Langlois and Faraggi were ordinary dividends and therefore taxable.

[68] The parties agree that only the existence of a sham can justify the conclusion reached by the TTC judge. The dispute centres on the scope of this concept and its application to the facts at hand.

[69] As indicated earlier, the mere fact that the transactions that led to the payment of these dividends may have resulted in an abuse of the Act is not, in itself, enough to conclude that they are shams. Moreover, if this concept is applied in conformity with the case law which, as we have seen, requires an element of deceit, it is difficult to see how the TCC judge could find that the daylight overdraft granted by the Royal Bank for a short time on August 13, 1987, was a sham (Reasons, paragraph 90). It is true that, as the TCC judge pointed out, the funds could not have been used for any purpose other than for the particular purpose for which they were

advanced, and that, in that sense, the borrowers did not have “absolute enjoyment” of the funds. But the fact that a loan is extended for a particular purpose is not exceptional. In that regard, the evidence reveals that the funds were used for the purpose for which the advance was authorized and that each of the $10,000,000 cheques certified by the Royal Bank guaranteed the payment of the stated value (Testimony of Alain Lapointe, Appeal Book (A-300-07), pages 95 and 96 (1916 and 1917)).

[70] Moreover, the fact that the cost of the loan was paid by way of a service charge rather than interest is also no reason to conclude that the loan was bogus. Either way, the cost of the loan was the same ($10,000 was charged as a service fee, while the interest payable on a daylight overdraft would have been $10,000, that is, a tenth of one per cent (*idem*, pages 98 et 99 (1937 and 1938)). With respect, it is not possible to conclude that the Royal Bank, the devisers and the first subsidiary misrepresented their relationship of lender/borrower. The loan cannot be held to be a sham.

[71] Similarly, the promissory notes issued by the first subsidiary ($110,000,000 in total) cannot be qualified as shams (Reasons, paragraphs 91 and 92). The TCC judge made the point that first subsidiary did not have the funds to honour the notes. However, according to the evidence, it was not contemplated that the promissory notes would be used as a means of payment. Their only function was to attest to the existence of the debt incurred by the first subsidiary following the purchase of the gain-making shares (Appeal Book (A-300-07), Volume II, “Statement of Facts”, paragraphs 125 to 130, 140 to 145, 155 to 160, 170 to 175, 185 to 190,

200 to 205, 215 to 220, 230 to 235, and 245 to 250). The fact that the devisers had planned for the debts to be discharged by another mode of payment does not make the promissory notes shams. In fact, the record reveals that all the debts recognized by the promissory notes were honoured either by payment or by compensation, a legitimate payment method in Quebec civil law (Appeal Book (A-300-07), Volume V, "Book of Account", pages 908 to 923).

[72] However, I am of the opinion that the transactions that generated the alleged capital gains amounting to a total of some $234 million were misrepresented and that the resulting elections made by the subsidiaries and the corporate appellants were shams in the accepted meaning of the word. A sale of shares does not result in a capital gain simply because one decides to call it that. It is the nature of the property in the hands of the person who disposes of it that determines the tax treatment of the transaction. As a general rule, property that is capital in nature is property owned for the long term with a view to its appreciation in value or in order to earn income from it, such as rent, interest or, in the case of shares, dividends. At the other extreme, property acquired for resale is held on account of revenue. Although the characterization of property for tax purposes is difficult when one moves away from these extremes, this becomes obvious when the situation falls at one of these extremes.

[73] In the case at hand, the gain-making shares were acquired by the subsidiaries for the purpose of their immediate sale. The terms of the plan allow for no other scenario. This excludes the possibility that the shares could have been capital property in the hands of the subsidiaries. As counsel for the respondent pointed out during the proceeding, the fact that the subsidiaries

acquired the gain-making shares through stock dividends is of no assistance since each of the steps, including the mode of acquisition of these shares, was decided in advance by the devisers of the plan.

[74] This is the missing link in the devisers' strategy. It is not surprising that they did not see fit to ask Mr. Régnier to opine on the manner in which the CDAs were created. This aspect of the plan was specifically excluded from Mr. Régnier's mandate (Testimony of Mr. Régnier, Appeal Book (A-300-07), Volume X, page 128 (1949), lines 5 and 6). The simple fact that the acquisition of the gain-making shares by the subsidiaries and their sale had been pre-ordained eliminates the possibility that a favourable opinion could have been obtained. When confronted with this during the hearing, counsel for the appellants was unable to explain how the gain-making shares could be viewed as capital property in the hands of the subsidiaries.

[75] The evidence reveals that this issue was raised during the marketing phase of the plan by Mr. Tom Gillespie, an experienced tax practitioner with the law firm Ogilvie Renault. Mr. Gillespie insisted on knowing the source of the capital gains before issuing a favourable opinion for the benefit of clients interested in the scheme. No answer was given. Mr. Gillespie was informed that he did not need to know the source of the CDAs, as this had no bearing on the opinion he was to provide. The clients in question who were considering a major investment ($50,000,000) decided not to participate (Testimony of Ralph E. Faraggi, Appeal Book (A-300-07), Volume VII, pages 54 to 57, and 62 (1322 to 1324, and 1329)). The limited scope of

the mandate given to Mr. Régnier and the position taken in response to Mr. Gillespie's request tend to suggest that the devisers were aware of the flaw in their plan.

[76] Despite the fact that no capital gains were generated, each of the second to twelfth subsidiaries took the position that it had generated such gains. The prescribed form and schedule filed with the Minister following the payment of the deemed dividend to the first subsidiary (i.e., the elections) set out the computation of the CDA and its source. According to the prescribed information submitted by the subsidiaries, the disposition of the gain-making shares had generated capital gains, and these gains were the source of their CDAs (see, for example, form T-2054 and the schedules filed by 2529-0099 Québec Inc. (the second subsidiary), Appeal Book (A-300-07), Volume V, pages 841 to 844).

[77] In making these elections, the subsidiaries misrepresented to the Minister and to all those affected by these elections that the disposition of the gain-making shares had resulted in capital gains, half of which formed part of their CDAs. They further misrepresented that the deemed dividends paid to the first subsidiary came from these CDAs when they knew that no CDA had been created in the first place. The first subsidiary, in turn, misrepresented the facts when it indicated in its election that the dividend declared in favour of 1915 Inc. came from its CDA, even though it knew that no CDA had been transferred to it by the subsidiaries. Finally, 1915 Inc. misrepresented the facts when it indicated in its election that the cash dividends paid to the devisers came from its CDA, when it knew that no CDA had been transferred to it by the first subsidiary.

[78] Despite the impression given, no capital gains were made and no CDAs were created. In this regard, I agree with the TCC judge's statement at paragraph 94 of his reasons:

> … To have made an election pursuant to subsection 83(2) in these circumstances is, to put it mildly, dishonest …

[79] The initial elections were shams since they misrepresented the transactions that had taken place between the subsidiaries as being capital transactions. The subsequent elections were also shams since they represented that dividends were paid out of a CDA when none had been created and none could thereafter be transferred. In my opinion, the TCC judge correctly relied on the real transactions, which produced no capital gains, to conclude that the dividends ultimately received by the devisers were not capital dividends and were therefore taxable.

[80] The devisers' alternative argument that the dividends remained capital dividends even though the subsidiaries generated no capital gains must also fail. It is true that subsection 83(2) provides that a dividend that is made the subject of an election is deemed to come from the CDA of the payer corporation. But, according to its wording, this presumption is effective only "to the extent of" the payer corporation's CDA. When the payer corporation does not have a CDA, as was the case of the eleven subsidiaries that made the first election, the presumption has no effect.

[81] The devisers' additional argument that subparagraph 89(1)(*b*)(ii) has the effect of creating valid CDAs in the hands of transferees even where their initial creation was a sham must

also be rejected. The devisers as the authors of the sham cannot rely on subsequent events to validate the CDAs from which they received the dividends.

[82] I also do not believe that the Minister was bound to proceed pursuant to Part III on the facts of this case. The provisions of Part III deal with excessive elections. They allow corporations that pay dividends exceeding the value of their CDAs to correct their mistake and avoid the special tax provided for under Part III. Like the TCC judge, I do not believe that Parliament intended these provisions to apply when, as here, the initial CDA was sham, and those claiming the benefit of Part III are the authors of the sham.

[83] Lastly, the fact that the Minister has not to date assessed the subsidiaries to offset the capital gains they claimed to have generated does not preclude the assessments issued against the appellants.

PENALTIES

[84] Counsel for the appellants did not dwell on the TCC judge's decision regarding the penalties. He explained during the proceeding that his clients' fate turns on their liability for the assessed tax (and interest) and that the offsetting of the penalties, with nothing more, would be of little use.

[85] The TCC judge found that the four appellants were grossly negligent in failing to report their respective incomes/dividends. It has not been established that he erred in coming to this conclusion.

[86] I would therefore dismiss the four appeals with costs.

"Marc Noël"
J.A.

"I agree.
M. Nadon J.A."

"I agree.
Johanne Trudel J.A."

Certified true translation
Susan Deichert, Reviser

FEDERAL COURT OF APPEAL

SOLICITORS OF RECORD

DOCKET:	A-297-07

(APPEAL FROM THE JUDGMENT OF THE HONOURABLE ASSOCIATE CHIEF JUSTICE RIP OF THE TAX COURT OF CANADA, DATED MAY 23, 2007, DOCKET NO. 96-1460(IT)G)

STYLE OF CAUSE:	2529-1915 Québec Inc. v. Her Majesty the Queen
PLACE OF HEARING:	Montréal (Quebec)
DATE OF HEARING:	October 22, 2008
REASONS FOR JUDGMENT BY:	Noël J.A.
CONCURRED IN BY:	Nadon J.A. Trudel J.A.
DATED:	December 12, 2008

APPEARANCES:

Paul Ryan Kathy Kupracz	FOR THE APPELLANT
Benoit Mandeville	FOR THE RESPONDENT

SOLICITORS OF RECORD:

Ravinsky Ryan Lemoine LLP Montréal (Quebec)	FOR THE APPELLANT
John H. Sims, Q.C. Deputy Attorney General of Canada	FOR THE RESPONDENT

FEDERAL COURT OF APPEAL

SOLICITORS OF RECORD

DOCKET:	A-298-07

(APPEAL FROM THE JUDGMENT OF THE HONOURABLE ASSOCIATE CHIEF JUSTICE RIP OF THE TAX COURT OF CANADA, DATED MAY 23, 2007, DOCKET NO. 96-1457(IT)G)

STYLE OF CAUSE:	2530-1284 Québec Inc. v. Her Majesty the Queen
PLACE OF HEARING:	Montréal (Quebec)
DATE OF HEARING:	October 22, 2008
REASONS FOR JUDGMENT BY:	Noël J.A.
CONCURRED IN BY:	Nadon J.A. Trudel J.A.
DATED:	December 12, 2008

APPEARANCES:

Paul Ryan Kathy Kupracz	FOR THE APPELLANT
Benoit Mandeville	FOR THE RESPONDENT

SOLICITORS OF RECORD:

Ravinsky Ryan Lemoine LLP Montréal (Quebec)	FOR THE APPELLANT
John H. Sims, Q.C. Deputy Attorney General of Canada	FOR THE RESPONDENT

FEDERAL COURT OF APPEAL

SOLICITORS OF RECORD

DOCKET:	A-299-07

(APPEAL FROM THE JUDGMENT OF THE HONOURABLE ASSOCIATE CHIEF JUSTICE RIP OF THE TAX COURT OF CANADA, DATED MAY 23, 2007, DOCKET NO. 96-1459(IT)G)

STYLE OF CAUSE:	Robert Langlois v. Her Majesty the Queen
PLACE OF HEARING:	Montréal (Quebec)
DATE OF HEARING:	October 22, 2008
REASONS FOR JUDGMENT BY:	Noël J.A.
CONCURRED IN BY:	Nadon J.A. Trudel J.A.
DATED:	December 12, 2008

APPEARANCES:

Paul Ryan Kathy Kupracz	FOR THE APPELLANT
Benoit Mandeville	FOR THE RESPONDENT

SOLICITORS OF RECORD:

Ravinsky Ryan Lemoine LLP Montréal (Quebec)	FOR THE APPELLANT
John H. Sims, Q.C. Deputy Attorney General of Canada	FOR THE RESPONDENT

FEDERAL COURT OF APPEAL

SOLICITORS OF RECORD

DOCKET:	A-300-07

(APPEAL FROM THE JUDGMENT OF THE HONOURABLE ASSOCIATE CHIEF JUSTICE RIP OF THE TAX COURT OF CANADA, DATED MAY 23, 2007, DOCKET NO. 96-1458(IT)G)

STYLE OF CAUSE:	Ralph E. Faraggi v. Her Majesty the Queen
PLACE OF HEARING:	Montréal (Quebec)
DATE OF HEARING:	October 22, 2008
REASONS FOR JUDGMENT BY:	Noël J.A.
CONCURRED IN BY:	Nadon J.A. Trudel J.A.
DATED:	December 12, 2008

APPEARANCES:

Paul Ryan Kathy Kupracz	FOR THE APPELLANT
Benoit Mandeville	FOR THE RESPONDENT

SOLICITORS OF RECORD:

Ravinsky Ryan Lemoine LLP Montréal (Quebec)	FOR THE APPELLANT
John H. Sims, Q.C. Deputy Attorney General of Canada	FOR THE RESPONDENT