Docket: 2008-1724(IT)G

BETWEEN:

LESLIE EMORY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeal heard on December 3, 2009 at Ottawa, Canada

By: The Honourable Justice Judith Woods

Appearances:

| | |
|---|---|
| Counsel for the Appellant: | Adam Aptowitzer |
| Counsel for the Respondent: | Pascal Tétrault |

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**JUDGMENT**

The appeal with respect to assessments made under the *Income Tax Act* for the 2002, 2003 and 2004 taxation years is dismissed, with costs to the respondent.

Signed at Ottawa, Canada this 4th day of February 2010.

"J. M. Woods"

Woods J.

Citation: 2010 TCC 71
Date: 20100204
Docket: 2008-1724(IT)G

BETWEEN:

LESLIE EMORY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

## REASONS FOR JUDGMENT

**Woods J.**

[1] This appeal relates to the arm's-length deeming rules in section 84.1 of the *Income Tax Act.*

[2] In 2002, the appellant, Leslie Emory, sold shares in the capital of Sona Computer Inc. (“Sona”) for cash proceeds of $400,000. The purchaser was 1514488 Ontario Inc. (“Ontario Inc.”).

[3] The gain from the sale was reported by the appellant as a capital gain which was eligible for the capital gains exemption.

[4] In a reassessment for the 2002 taxation year, the Minister of National Revenue considered that section 84.1 of the *Act* applied to the disposition. As a result, the Minister included $492,387 in the appellant’s income as a taxable dividend.

[5] Ms. Emory appeals from this assessment as well as consequential assessments for the 2003 and 2004 taxation years.

[6] The main issue is whether section 84.1 applies to the disposition of the shares of Sona. There are also incidental issues with respect to the 2003 and 2004 taxation years that are relevant if the appellant is successful on the main issue.

Background facts

[7] The relevant facts, which are not in dispute, are set out as assumptions in the reply. They are reproduced below. Corporate organization charts which were prepared by the appellant's counsel are reproduced in an appendix.

*Minister's assumptions*

a) on March 24, 1992, Sona Computer Inc. (Sona) was incorporated;

b) in July 2001, Leslie Emory (Emory) and Xuening Chen (Chen) held 20 and 55 common shares of Soma [sic], respectively, which represented all of the issued and outstanding shares of the corporation;

c) on February 23, 2000, Foxwise Technologies Inc. (Foxwise) was incorporated;

d) in July 2001, Emory, Chen and Sam Damm held 24, 25 and 51 common shares of Foxwise, respectively, which represented all of the issued and outstanding shares of the corporation;

e) on June 2, 2002, 1514488 Ontario Inc. (Ontario Inc.) was incorporated;

f) at all material times, Emory and Chen held 5 and 95 common shares of Ontario Inc., respectively, which represented all of the issued and outstanding common shares of the corporation;

g) on September 3, 2002, Emory and Chen disposed of their shares of Sona and Foxwise to Ontario Inc.;

h) on September 3, 2002, Emory received as consideration for her shares of Sona and Foxwise an amount of $400,000;

i) Emory's adjusted cost base of her shares of Sona and Foxwise was $2,000 and $24, respectively;

j) the portion of the consideration of $400,000 attributable to the shares of Foxwise was nominal;

k) on September 3, 2002, Chen received as consideration for his shares of Sona and Foxwise, 1100 Special Shares of Ontario Inc. by way of "rollover" pursuant to section 85 of the *Income Tax Act*;

l) on September 3, 2002, Ontario Inc. held all of the issued and outstanding shares of Soma [sic];

m) on September 3, 2002, Ontario Inc. held 49 of the 100 issued and outstanding common shares of Foxwise;

n) on September 25, 2002, Sona declared and paid a dividend of $400,000 to Ontario Inc.; and

o) at all relevant times, Emory, Chen, Soma, Foxwise and Ontario Inc, were Canadian residents.

The issue

[8] The primary question is whether Ms. Emory and Ontario Inc. were not dealing at arm's length for the purposes of section 84.1 of the *Act*.

[9] The respondent suggests that they were not dealing at arm's length. The argument is founded not on the ordinary meaning of the term "arm's length," but on the extended meaning that is applicable for purposes of s. 84.1.

[10] The appeal relates to the disposition of shares in Sona and Foxwise. I do not propose to discuss the Foxwise shares in these reasons since the parties agree that their value was nominal.

Legislative scheme

[11] The general purpose of section 84.1 is described in a Department of Finance technical note, as follows:

> Section 84.1 is an anti-avoidance rule designed to prevent the removal of taxable corporate surplus as a tax-free return of capital through a non-arm's length transfer of shares by an individual resident in Canada to a corporation.

[12] The mischief at which the provision is aimed was discussed in greater detail by Peter S. Bowen in "The Effect of the June 22, 1992 Notice of Ways and Means Motion on Certain Corporate Reorganizations," (1992), vol. 40, no. 5 *Canadian Tax Journal* 1218-33, at 1214:

> In its present form, section 84.1 is primarily intended to prevent an individual from using the capital gains exemption (or any pre-1972 increase in value) to withdraw cash in excess of the paid-up capital of the shares, on a tax-free basis, from a corporation. For example, consider an individual who owns all of the shares of a corporation (Opco). The shares have a fair market value of $100,000 but have only a

> nominal paid-up capital and adjusted cost base. Assume that this individual has not yet used her capital gains exemption, and is not restricted by any cumulative net investment loss. Ordinarily, the individual would withdraw cash from the corporation by way of a dividend, which would be taxed in her hands. But for the existence of section 84.1, the individual could withdraw cash on a tax-free basis by undertaking a simple reorganization. For instance, the individual could transfer the subject shares to a holding corporation (Holdco) in exchange for a debt equal to the fair market value of the shares. The resulting gain would be sheltered by the capital gains exemption. The two corporations could subsequently amalgamate, and the debt could be paid by the amalgamated company. Alternatively, Opco could pay a tax-free dividend to Holdco to finance repayment of the debt. In either case, $100,000 would have been withdrawn from Opco at no tax cost. Paragraph 84.1(1)(b) acts in such circumstances to deem a dividend to have been paid to the individual, and thus prevents the removal of the surplus. The deemed dividend, in this case, is calculated as the excess of the debt received over the greater of the paid-up capital and adjusted cost base of the subject shares.

[13] The general requirements for the application of section 84.1 are set out at the beginning of subsection 84.1(1). Among other requirements, there must be a non-arm's length relationship between the taxpayer who disposed of the shares and the corporation that acquired them.

[14] The relevant part of s. 84.1(1) reads:

> Where after May 22, 1985 a taxpayer resident in Canada (other than a corporation) disposes of shares that are capital property of the taxpayer (in this section referred to as the "subject shares") of any class of the capital stock of a corporation resident in Canada (in this section referred to as the "subject corporation") to another corporation (in this section referred to as the "purchaser corporation") with which the taxpayer does not deal at arm's length and, immediately after the disposition, the subject corporation would be connected (within the meaning assigned by subsection 186(4) if the references therein to "payer corporation" and to "particular corporation" were read as "subject corporation" and "purchaser corporation" respectively) with the purchaser corporation, […]
>
> (Emphasis added)

Analysis

[15] It is the submission of the respondent that Ms. Emory and Ontario Inc. do not deal at arm's length by virtue of a set of deeming rules in section 84.1. For the reasons below, I agree with this submission.

[16] The result follows from the interplay between paragraphs 84.1(2)(*b*) and (2.2)(*b*), (*c*) and (*d*) of the *Act*.

[17] I begin the analysis with paragraph 84.1(2)(*b*). It provides:

> (2) For the purposes of this section,
>
> […]
>
> (*b*) in respect of any disposition described in subsection (1) by a taxpayer of shares of the capital stock of a subject corporation to a purchaser corporation, the taxpayer shall, for greater certainty, be deemed not to deal at arm's length with the purchaser corporation if the taxpayer
>
> (i) was, immediately before the disposition, one of a group of fewer than 6 persons that controlled the subject corporation, and
>
> (ii) was, immediately after the disposition, one of a group of fewer than 6 persons that controlled the purchaser corporation, each member of which was a member of the group referred to in subparagraph (i);

[18] Pursuant to this provision, Ms. Emory is deemed not to deal at arm's length with Ontario Inc. if:

(a) immediately before the disposition, Ms. Emory was one of a group of fewer than six persons that controlled Sona, and

(b) immediately after the disposition, Ms. Emory was one of a group of fewer than six persons that controlled Ontario Inc., and each member of this group was a member of the group described in (a).

[19] Were it not for other deeming provisions, neither of the above requirements would be satisfied because Ms. Emory would not be part of a group that controlled either Sona or Ontario Inc. There are two reasons for this.

[20] First, it is not suggested that Ms. Emory acted in concert with the other shareholder, Mr. Chen, in controlling either Sona or Ontario Inc. This is a necessary requirement in order to find that a group controls a corporation: *Silicon Graphics Ltd. v. The Queen*, 2002 FCA 260, 2002 DTC 7112, at para 36.

[21] Second, Mr. Chen alone controlled Sona and Ontario Inc. This would preclude Ms. Emory from being part of a group that controlled these corporations: *Southside Car Market Ltd. v. The Queen*, 82 DTC 6179 (FCTD).

[22] The principles from *Silicon Graphics* and *Southside Car Market* have been statutorily overridden for purposes of s. 84.1.

[23] The relevant provisions, paragraphs 84.1(2.2)(*b*), (*c*) and (*d*), read:

> (2.2) For the purpose of paragraph (2)(*b*),
>
> […]
>
> (*b*) a group of persons in respect of a corporation means any 2 or more persons each of whom owns shares of the capital stock of the corporation;
>
> (*c*) a corporation that is controlled by one or more members of a particular group of persons in respect of that corporation is considered to be controlled by that group of persons; and
>
> (*d*) a corporation may be controlled by a person or a particular group of persons even though the corporation is also controlled or deemed to be controlled by another person or group of persons.

[24] As a result of the application of these provisions, Ms. Emory and Mr. Chen are considered to be a group that: (1) controlled Sona immediately before the disposition, and (2) controlled Ontario Inc. immediately after the disposition. The analysis is set out below.

[25] First, Ms. Emory and Mr. Chen are considered to be a group of persons in respect of Sona and Ontario Inc. at the relevant times: s. 84.1(2.2)(*b*).

[26] Second, Sona and Ontario Inc. were controlled by this group: s. 84.1(2.2)(*c*) and (*d*). In particular, Sona and Ontario Inc. were each controlled by Mr. Chen at the relevant times because he owned more than 50 percent of the voting shares of these corporations. In this circumstance, the group of persons that includes Mr. Chen, namely Ms. Emory and Mr. Chen, are considered to have controlled Sona and Ontario Inc.

[27] Accordingly, the necessary conditions of s. 84.1(2)(*b*) are satisfied so that Ms. Emory is deemed not to deal at arm’s length with Ontario Inc.

[28] Counsel for the appellant acknowledges that the plain meaning of the relevant provisions produces this result. However, he suggests that the plain meaning does not reflect the object and spirit of the legislation and that a purposive interpretation is more appropriate.

[29] First, counsel suggests that subparagraphs 84.1(2)(*b*)(i) and (ii) are meaningless if the plain meaning is given to s. 84.1(2.2)(*b*).

[30] The analysis above shows the fallacy of this argument. Subparagraphs 84.1(2)(*b*)(i) and (ii) are not meaningless. Paragraph 84.1(2)(*b*) provides the framework for the expansion of the meaning of the term “arm’s length.”

[31] Second, counsel suggests that this interpretation can lead to absurd and repugnant results because it disregards the actual facts concerning lack of control.

[32] I can understand why counsel would suggest that these rules could have inappropriate results. For many years, commentators have noted that section 84.1 is a trap for the unwary. See, for example, the article by Peter Bowen referred to above. However, Parliament has clearly provided for this result, presumably in order to limit the potential for abuse.

[33] Third, counsel suggests that this interpretation conflicts with public positions taken by the Minister. It is suggested that the Minister has acknowledged that a common link or interest between members of the group is required: 1995 Revenue Canada Roundtable, at 52:10 and Interpretation Bulletin IT-302R3, para. 3.

[34] With respect, I am not satisfied that these commentaries were intended to apply to the legislative provisions that are relevant in this appeal.

[35] Fourth, it is suggested that a plain meaning interpretation is inconsistent with case law such as *Silicon Graphics*. It is suggested that there is no appreciable difference between the statutory provisions at issue here and in *Silicon Graphics*.

[36] I reject this submission. The statutory provision that was relevant in *Silicon Graphics* was the definition of “Canadian-controlled private corporation” in subsection 125(7) of the *Act*. It did not contain deeming rules similar to those at issue here.

[37] Further, counsel submits that this interpretation renders the word “particular” in s. 84.1(2.2)(*c*) meaningless.

[38] I also disagree with this submission. The word “particular” in s. 84.1(2.2)(*c*) is necessary because a corporation with several shareholders could have many “groups” for purposes of the analysis. It is necessary to specify which particular group is to be considered for purposes of s. 84.1(2.2)(*c*).

[39] Finally, counsel submits that the plain meaning interpretation is counter to the purpose of s. 84.1.

[40] I also disagree with this submission. It is clear that section 84.1 is an anti-avoidance provision that is designed to prevent the tax-free extraction of corporate surplus. It is also clear, though, that the provision could potentially overreach its anti-avoidance objective in certain cases. This result was clearly intended by Parliament, in my view.

[41] It is perhaps worth mentioning that section 84.1 would not have applied to the disposition by the appellant of shares of Sona if the appellant had not owned any shares in Ontario Inc. The fact that the appellant owned a small number of shares in Ontario Inc. has unfortunately resulted in the application of this section.

Disposition

[42] The appeal with respect to assessments for the 2002, 2003 and 2004 taxation years is dismissed. The respondent is entitled to costs.

Signed at Ottawa, Canada this 4th day of February 2010.

"J. M. Woods"

Woods J.

# Appendix

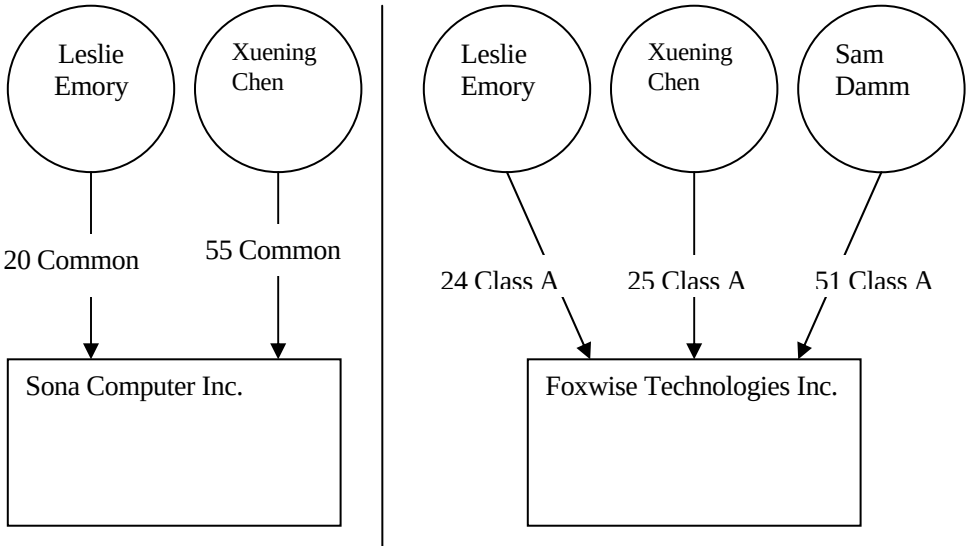


Figure 1. Ownership structure of Sona and Foxwise as of September 2, 2002.

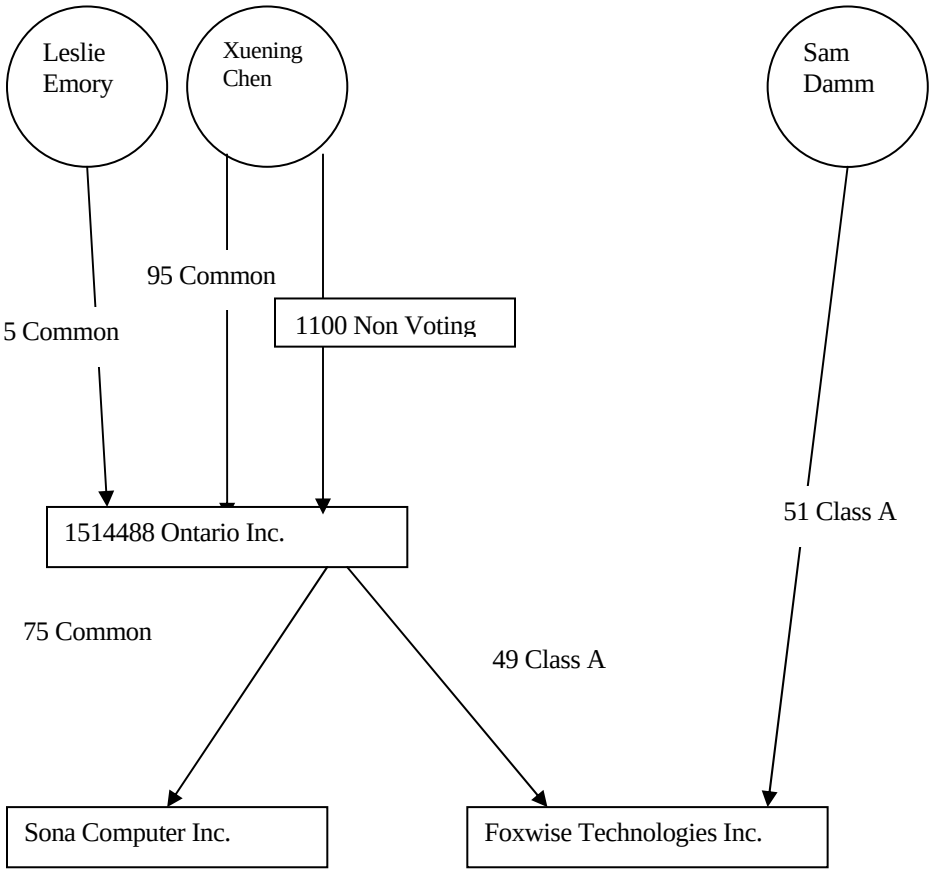


Figure 2. Ownership structure of Sona and Foxwise as of September 3, 2002.

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|---|---|
| CITATION: | 2010 TCC 71 |
| COURT FILE NO.: | 2008-1724(IT)G |
| STYLE OF CAUSE: | LESLIE EMORY and<br>HER MAJESTY THE QUEEN |
| PLACE OF HEARING: | Ottawa, Canada |
| DATE OF HEARING: | December 3, 2009 |
| REASONS FOR JUDGMENT BY: | The Honourable Justice J. M. Woods |
| DATE OF JUDGMENT: | February 4, 2010 |

APPEARANCES:

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| Counsel for the Respondent: | Pascal Tétrault |

COUNSEL OF RECORD:

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