Docket: 2009-1(IT)G

BETWEEN:

DR. ROBERT G. MACDONALD,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on September 21 and 22, 2011 at Fredericton, New Brunswick

Before: The Honourable Justice J.E. Hershfield

Appearances:

Counsel for the Appellant: J. Paul M. Harquail

Counsel for the Respondent: David I. Besler

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2002 taxation year is allowed, with costs, and the reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with and for the reasons set out in the attached Reasons for Judgment.

Signed at Ottawa, Canada this 17th day of April 2012.

"J.E. Hershfield"

Hershfield J.

Citation: 2012 TCC 123
Date: 20120417
Docket: 2009-1(IT)G

BETWEEN:

DR. ROBERT G. MACDONALD,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Hershfield J.

Issues

[1] The Appellant was assessed to include a taxable dividend in the amount of $524,967 in his income for the 2002 taxation year pursuant to subsection 84(2) of the *Income Tax Act* (the "*Act*"). That subsection deems a dividend to have been received when a company distributes funds to a shareholder on a winding up, discontinuance, or reorganization of a business.

[2] The transactions assessed as invoking this provision of the *Act* included a non-arm's length sale of the Appellant's shares in Robert G. MacDonald Professional Corporation Ltd. ("PC") in 2002 (the "share sale").

[3] The assessment also relied on section 245 of the *Act*, the provision commonly referred to as the General Anti-Avoidance Rule ("GAAR").

[4] A further basis for the assessment was that the share sale, funded by way of a series of related transactions with funds provided by PC, was a sham. The sham basis for the assessment was abandoned at trial.

[5] The Appellant had reported the amount at issue as a capital gain arising from the share sale on the basis of receiving proceeds of disposition of $525,068 and as having an adjusted cost base of $101. The Appellant had capital losses and capital loss carry forwards (net capital losses) available to shelter part of the capital gain triggered on the share sale. The assessment, applying subsection 84(2), deemed the amount received by the Appellant on the disposition, less $101 being the paid-up capital of the shares sold, to have been received as a dividend.[1]

[6] The issue raised by the appeal is whether subsection 84(2) applies on the facts of this case or whether, in any event, GAAR applies to give the same result. Further, in the event the subject amount is to be treated as a dividend, another question was raised by the Appellant: namely, whether filing his tax return for the subject year on the basis that he was a resident of Canada at the time of the share sale was, in fact, correct. Detailed evidence was given at the hearing relating to his taking up residency in the United States so as to afford the Court the opportunity to answer that question.

[7] If the Appellant was not a resident of Canada at the time of the share sale, the deemed disposition rules in paragraph 128.1(4)(*b*) of the *Act* would apply and the tax payable on the deemed divided would be governed by section 212 of the *Act* and by the Canada–United States Income Tax Convention.[2]

How Evidence was Presented

[8] There was a partial Agreed Statement of Facts filed at the hearing. It is appended to these Reasons as Schedule 1. It describes the transactions surrounding the share sale. In effect, it concedes that the manner by which the share sale was carried out was by way of a non-arm's length series of transactions designed to give the Appellant access to essentially all of the assets of PC.

[9] However, the Appellant also testified at the hearing. His testimony, the credibility and reliability of which Respondent's counsel openly acknowledged, provided the background leading up to the share sale, the related transactions, and

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[1] As well the assessment increased the proceeds of disposition of the shares by $10,000, the full amount of which was treated as a capital gain. Such part of the assessment was abandoned at trial.

[2] Convention between Canada and the United States of America with respect to Taxes on Income and Capital, signed at Washington D.C. on September 26, 1980, amended by Protocols done on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 ["Canada-U.S. Tax Treaty"].

the reasons for the manner chosen to implement those transactions. His elaboration of the transactions afforded counsel the opportunity to clarify some uncertainties contained in the partial Agreed Statement of Facts.

[10] As well, his testimony detailed with some exactitude the events relating to his departure from Canada and his taking up residence in the United States. This evidence is relevant to the alternative argument raised by the Appellant in the event that I found that subsection 84(2) applied, namely whether he was already a resident of the United States at the time of payment of the deemed dividend arising out of the application of that provision. On filing his return for the year, the Appellant took the position that the share sale and the capital gain took place on June 25, 2002 while he was still a resident of Canada. The Respondent has never taken issue with this filing position and rejects the Appellant's alternative position that his residence changed before the share sale or before any distribution or appropriation of PC's assets occurred.

[11] It might be easiest and fairest to deal with the Appellant's testimony before looking at, and elaborating on, the series of transactions implementing the share sale.

Background Facts

[12] As noted, the testimony of the Appellant was not challenged. Accordingly, his evidence was accepted as factual, except where it was admitted to be uncertain in terms of his recollection of certain events going as far back as 2000 when events leading to his departure from Canada first began.

[13] The Appellant's testimony includes the following background:

- After completing medical studies in Canada, the Appellant did post-graduate work in the United States where he met his wife Dale Paley, a US citizen who was then completing her studies in veterinary medicine. The Appellant was in the United States on a visa that required his return to Canada on completion of his studies. His studies resulted in his obtaining a cardiologist's specialty designation known as an interventionist heart surgeon. He returned to Canada in 1986 by taking a position in Halifax. Ms. Paley came with him and they were soon married, a step that facilitated her Canadian studies in veterinary medicine. Later, in 1991, the Appellant and his wife moved to New Brunswick where the Appellant took a position with

the New Brunswick Heart Centre at the Saint John Regional Hospital. His association there lasted until his departure from Canada in 2002.

- The Appellant performed his services for the New Brunswick Heart Centre as an employee of his professional corporation, namely PC, which was incorporated under the laws of New Brunswick on September 4, 1991. From the incorporation of PC until well after his departure from Canada in 2002, the Appellant was its sole director and officer. He was the sole shareholder until the share sale. PC changed its name to 050509 N.B. Ltd. on June 26, 2002 as part of the series of transactions required as a consequence of his moving to the United States and of his ending his medical practice in New Brunswick.[3]

- The New Brunswick Heart Centre housed many independent practitioners, including the Appellant's practice. The hospital leased space to these practitioners, and provided secretarial help. There was a common billing system among the practitioners, but each cared for their own patients. Over the decade that the Appellant spent in Saint John, he had convinced many practitioners to join him at the hospital, but he remained the sole employee of PC.

- PC received income only from Medicare. PC held a billing number which was a requirement to practise medicine in New Brunswick.[4] PC billed Medicare for services. Medicare then sent a cheque in PC's name to the Appellant. The Appellant would deposit the cheque into an office bank account. A new cheque would be made out to PC based on its proportionate entitlement.

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[3] It is not in dispute that PC would lose and did lose its status as a professional medical corporation at the time of the share sale. Paragraph 31(3)(*f*) of the New Brunswick *Medical Act*, S.N.B. 1981, c. 87 requires the legal and beneficial ownership of all issued voting shares of a professional medical corporation be held by at least one or more members of the College of Physicians and Surgeons of New Brunswick.

[4] When a professional medical corporation ceases to be licensed, the billing number is not automatically terminated. According to subregulation 11(1.5) of the New Brunswick *General Regulation – Medical Services Payment Act*, the billing number may be used until it is revoked by the New Brunswick Department of Health.

- After practising medicine for over a decade in Canada, it became apparent to the Appellant that his wife wanted them to move back to the United States to live. Her veterinarian's practice was difficult to maintain and the weather was problematic for her.

- The Appellant started working toward emigrating to the United States in the year 2000. The process required many steps to be taken and satisfactorily completed in order for the Appellant to obtain the necessary status to reside and work in the United States with his wife. These steps include the following:

    - Being sponsored by his wife, a United States citizen, as an immigrant;

    - Showing an intention to become a United States resident, including buying a house in the United States and listing his Canadian house for sale;

    - Signing a letter of agreement to join a practice in Greenville, North Carolina.[5] The Appellant was paid recruiting expenses and a signing bonus by that practice, which he was obligated to refund if he did not join the practice;

    - Certifying two automobiles he bought in Canada for export to the United States, including ensuring that the vehicles met US Environmental Protection Agency regulations and US federal safety requirements.[6]

- On June 5, 2002, the United States Consulate in Montreal issued an "Immigrant Visa and Alien Registration" document. The visa expired at midnight, December 4, 2002, meaning the Appellant needed to leave Canada and take up residency in the United States by December 4 of that year.

- As required by the visa, the Appellant left Canada prior to its expiry date by crossing the border with his wife. They crossed at 5:30 p.m., Eastern

[5] Shortly after joining this practice, the Appellant moved to South Carolina to join a different medical facility.

Standard Time, on June 25, 2002 taking with them all their personal property.

- Further actions taken relating to this departure from Canada included:

  - Meeting with the moving company at the border on June 25, 2002 to ensure records reflected a permanent exporting of their personal property to the United States;

  - Setting up his practice in the United States by joining many medical societies and associations. He obtained his license from the North Carolina licensing body which was required for him to practise medicine there. Shortly after, he was licensed by the South Carolina Medical Association which enabled him to practise medicine at the medical facility where he still works today;

  - Surrendering his New Brunswick driver's license and obtaining a North Carolina license;

  - Opening a bank account in North Carolina.

[14] While the forgoing describes steps taken to affect his immigration to the United States, it is necessary to set out the evidence relating more specifically to his severance of ties from Canada. I will divide that evidence into two parts: the Appellant's additional testimony dealing with the wind-up of his professional and personal ties and affairs in Canada; and, his evidence dealing with his investment in PC and the share sale. I will deal firstly with his evidence dealing with areas of his severance other than those dealing with his holdings in PC.

[15] In severing his ties to Canada other than his investment in PC, his evidence was as follows:

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[6] The last step itemized was completed after the Appellant obtained his visa but prior to his departure, although, the vehicles remained licensed in Canada until they were re-licensed after his departure. Aside from that, all the steps itemized in this series of bulleted paragraphs were completed prior to obtaining the visa.

- Prior to June 25, 2002 he sold his house in New Brunswick and disposed of many chattels he no longer needed.[7]

- Prior to June 25, 2002, he allowed his New Brunswick medical license to expire, as well as resigning from his practice and numerous medical associations and societies. However, he is still a member of Royal College of Physicians.

- Prior to June 25, 2002, he gave notice to the Saint John Regional Hospital that he was ceasing to practise medicine in New Brunswick.

- He caused his accountants, Teed Saunders Doyle & Co., to prepare the necessary T4 form for remuneration from his listed employer, 050509 N.B. Ltd. (formerly PC). The T4, filed after the Appellant's departure, was required because Medicare paid, as it did in the normal course, between six to eight weeks after a professional invoiced the province for services provided. That is, 050509 N.B. Ltd. was receiving funds after June 25, 2002 for entitlements PC earned prior to June 25, 2002. Such receipts were accounted for as remuneration paid to the Appellant as an employee of 050509 N.B. Ltd..

[16] This takes me to the Appellant's dealings with PC.

[17] As a preliminary matter, I reiterate what I noted earlier: the Appellant had, unrelated to the transactions under review in this appeal, suffered personal capital losses and personal capital loss carry forwards or net capital losses. These are the losses that sheltered the capital gain triggered by the share sale. I will frequently refer to these personal capital losses and personal capital loss carry forwards as such, as did the parties although more technically it appears that we are talking about the Appellant's net capital losses.

[18] In any event, the decision to leave Canada caused the Appellant, as one might expect, to seek tax advice from his accountant.

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[7] I gather that, with two noted exceptions, the Appellant retained no assets in Canada at the time of his departure other than those entitlements that arose pursuant to the share sale. The exceptions were a horse that was shipped after his departure and an RRSP which he did not liquidate before leaving Canada. The value of the RRSP had diminished significantly for the same reason the Appellant incurred capital losses as described later in these Reasons. There has not been any activity in his RRSP since leaving Canada.

[19] His accountant advised that the departure could cause significant income tax problems given the deemed disposition rules under the *Act*. The problem described to him was that a deemed disposition of his PC shares would trigger capital gains tax in Canada on his capital gain but that the United States would not recognize an increase in the cost base of those shares. Accordingly, on the actual disposition of the PC shares after his departure, the entire capital gain would be taxable in the United States, based on his residency there.[8]

[20] That is, while the Appellant could use his personal capital losses and carry forwards to off-set the capital gain in Canada arising from the deemed disposition under the *Act* of his PC shares, that would provide no protection against recognition of a potential future capital gain in the United States measured from his original cost of $101. In effect, the Appellant would lose the economic benefit of applying his personal capital losses against his gain in respect of his shares in PC.[9]

[21] Based on this concern, the Appellant was referred by his accountant to tax professionals in both the legal and accounting fields. As a result, a plan was devised to utilize the capital losses and loss carryovers available in Canada and while preventing a second taxable realization of his shares in PC in the United States.

[22] Initially, the advice was to sell his shares in PC in what I might refer to as an arm's length transaction, but that proved impractical, indeed impossible. As a going concern, providing the services of a medical doctor, there was no market for PC shares: there was no medical doctor who would want to inherit another doctor's corporate issues. Hence, the corporation had to be converted from a professional corporation to a holding company but again there was no market for its shares.

[23] A plan was devised whereby the assets of PC would be liquidated and its shares would be sold to the Appellant's brother-in–law J.S., a resident of Canada

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[8] It is noted that this double tax issue was later resolved by amending protocols to the Canada- U.S. Tax Treaty. See Canada-U.S. Tax Treaty at art. XIII(5).

[9] It is noteworthy that if the Appellant had simply left Canada without selling his PC shares and then wound up PC while in the Unites States, he would have sheltered his capital gain on his PC shares in Canada on departure, paid a Part XIII tax in Canada on the liquidating dividend and had a capital loss in Canada on the cancellation of his PC shares given the reduction of his proceeds of disposition under section 54 of the *Act*. From a pure Canadian perspective, he has avoided Part XIII tax at the cost of losing a net capital loss in Canada which may be of no value to him as a non-resident.

married to the Appellant's sister.[10] J.S. was a willing purchaser on being given a $10,000 spread between what he could extract from the company and what he would have to pay the Appellant for the shares; and, on being given a complete indemnity for any third party liability that he might incur as a result of his purchase of the PC shares. While it is acknowledged that, pursuant to the provisions of the *Act*, the Appellant and J.S. were not dealing at arm's length,[11] it was not asserted that the terms of the transactions involving J.S. would have been different, or required to have been different or substantially different, if J.S. had been dealing at arm's length with the Appellant.

[24] The plan, as described in the Agreed Statement of Facts and elaborated on at the hearing, was carried out as follows:

- 601798 NB Ltd. ("601 Ltd.") was incorporated by J.S. under the laws of New Brunswick on June 20, 2002. It acquired the shares in PC on June 25, 2002 from J.S. after J.S. had acquired them personally on that same day.[12] The transactions are well documented and each transaction that occurred on June 25, 2002 identifies the time of execution. The transactions are thereby readily identifiable as being in a particular sequence.

- The purchase by J.S. of the PC shares was paid by delivery of a promissory note by J.S. to the Appellant (the "J.S. note"). The purchase price was set out as a formula that gave rise to a total consideration of $525,068.[13]

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[10] The Agreed Statement of Facts states that PC assets consisted primarily of marketable securities, cash and accounts receivable and that in the months leading up to June 25, 2002, the Appellant caused PC to liquidate its investments.

[11] Section 251 of the *Act*.

[12] The Appellant testified that J.S. may have tried to use 601 Ltd. for other purposes than holding the shares in PC but that any such activities were short-lived. The Appellant's hearsay testimony on the activities of 601 Ltd., although not objected to, was not sufficient to dispel the assumption in the Reply to the Appellant's Notice of Appeal that at all times 601 Ltd. was an inactive holding company, all of the issued outstanding shares of which were owned by J.S.

[13] The exhibits tendered at the hearing showed the J.S. note in the amount of $500,000. However, the parties appeared to treat it as reflecting the full amount of the total consideration payable on the share sale, namely $525,068. I have treated it as the parties have treated it.

- J.S. transferred the PC shares to 601 Ltd. in consideration of receiving shares in 601 Ltd. and a note payable by 601 Ltd. to J.S. in the amount of $525,068 (the "601 Ltd. note").

- PC declared two dividends on June 25, 2002, one in the amount of $500,000 and the other in the amount of $10,000. On the same day, PC issued two cheques to 601 Ltd., as the PC shareholder at the time the dividend was declared, in partial payment of the $500,000 dividend. One was for $320,000 and the other was for $159,842. 601 Ltd. in turn endorsed the cheques to J.S. as partial payment of the 601 Ltd. note and J.S. in turn endorsed the cheques to the Appellant as partial payment of the J.S. note. The Appellant wrote a cheque to PC in the amount of an unrelated indebtedness to it, namely, $159,842. The cheques for $159,842 were off-setting and booked as such although never cashed. The cheque for $320,000 now held by the Appellant was never cashed or presented for payment at a bank but was booked as a payable to the Appellant. All such events occurred on June 25, 2002.

- As noted, PC changed its name to 050509 N.B. Ltd. on June 26, 2002. This was consistent with PC ceasing to be a professional corporation due to the Appellant no longer being a shareholder of the company and his ceasing to practise medicine in New Brunswick. For the most part, I will continue to refer to this company as "PC".

- PC declared a final dividend on September 1, 2002 to 601 Ltd. equal to the amount still owing on the 601 Ltd. note, namely $25,068. This amount plus the unpaid portion of the dividend declared on June 25, 2002 was, as an acknowledged indebtedness to J.S., booked by PC, on the direction of J.S., as an indebtedness to the Appellant.[14] Such direction was in satisfaction of J.S.'s remaining obligation under the J.S. note.
- On July 15, 2002, PC by cheque paid 601 Ltd. the amount of $10,000. The cheque was deposited on August 27, 2002.

- PC prepared Articles of Dissolution on July 31, 2002 and it was officially dissolved on February 4, 2005.

[25] It is important to note that the parties were in agreement as to the timing of the distribution and appropriation of PC's assets. That is, while they are not in

[14] In September, the Appellant's residence was the United States. If a dividend was paid to the Appellant in September, there would only be withholding tax on that dividend.

agreement as to the effect of such appropriations or distributions, they are in agreement as to the time that they occurred.

[26] That is, the issuance of cheques and promissory notes, despite not being paid or presented for payment in the usual way, were acknowledged as delivered in the sequences advanced at the hearing and such deliveries were accepted by the Respondent as the distributions or appropriations that were the subject of the hearing.[15] The net effect was that it was acknowledged that the book or journal entries, notional or actual, created genuine liabilities or book debts that constituted fully distributed and appropriated amounts. Therefore, it is of no relevance as to when money changed hands in a more literal sense. That is, it is of no relevance at all when and how funds were actually, eventually, distributed to the book creditor, namely the Appellant. The dates of the subject distributions then are as follows:

- June 25, 2002 prior to the 5:30 PM border crossing: $479,842
- September 1, 2002: $45,226

[27] While the time of the distributions and appropriations is not in dispute, the Respondent set out a number of assumptions in its Reply to the Notice of Appeal (the "Reply") dealing with the question of the *bona fide* purposes of the transactions. Most of those relate to the assessing position that the subject transactions were a sham. Since that position was abandoned at trial I will not dwell on those assumptions save two that the Appellant disputed:

> There was no *bona fide* purpose for the sale of shares to James Stewart other than to obtain the tax benefit to the Appellant; and
>
> The Appellant entered into the series of transactions with the primary intention of accessing the accumulated surplus of the P.C. in a manner that provided him with a tax benefit;

[28] As well, in describing the transactions entered into by the Appellant, the following admitted assumption was set out in the Reply:

> …

[15] Transcript of Proceedings at page 252, lines 15-16.

> gg) The gain, as claimed, was partly sheltered by capital losses that the Appellant incurred during the year as well as loss carry forwards from prior years;
>
> …

[29] Under the heading “Grounds Relied on and Relief Sought”, the Reply goes on as follows:

> …
>
> 18. Furthermore, the transactions entered into by the Appellant resulted in an abuse of the *Act* since they were part of an arrangement to circumvent the application of subsection 84(2) of the *Act*. There was no purpose for the transactions other than to provide the Appellant with the means for capital gains treatment and to avoid the ordinary consequences of distributions of corporate assets on the wind-up and discontinuance of business, as deemed dividends. Accordingly, the $525,068 is properly included in the Appellant’s income as dividends, pursuant to section 245 of the *Act*.
>
> ...

[30] Nowhere in the Reply does the Respondent expressly identify the “tax benefit” that needs to be identified for the purposes of section 245. Implicitly however, given the assumption in paragraph (gg) of the Reply referred to above, the benefit must be taken to be the use of capital losses and loss carry forwards that could not have been used had subsection 84(2) applied. That was certainly the position taken at trial although the general avoidance of dividend treatment sought to be imposed under subsection 84(2), regardless of the particular tax benefit achieved by avoiding it, seems to be an underlying and relevant concern to the Respondent in this case.

[31] As such, I do not think my analysis can ignore that concern even though it appears to me nothing more than a confusing if not troubling distraction from the “tax benefit” analysis required by section 245.

Statutory Provisions

[32] The relevant statutory provisions of the *Act* will be reproduced as necessary throughout these Reasons. A brief comment, however, is warranted. Although not expressly relied upon by the parties, I note here that the Respondent seeks to give effect to the assessment in a manner that invokes paragraph (*c*) of subsection 245(5):

> **245(5) Determination of tax consequences** -- Without restricting the generality of subsection (2), …

…
(c) the nature of any payment or other amount may be recharacterized, and
…

[33] On the other hand, I note section 246 was not expressly relied upon by the Respondent.

Respondent's Submissions

[34] The Respondent's submissions can be broken down as follows:

a. Subsection 84(2) applies. The words "in any manner whatever" are broad. The sale complements the winding-up of PC's business.

b. Section 245 applies.

    i. There is a tax benefit. It allowed a receipt to be categorized as a capital gain as opposed to a dividend, avoiding tax on the receipt by shielding the gain with off-setting net capital losses.

    ii. There was no *bona fide* purpose for the share sale.

    iii. There was a misuse or abuse of subsection 84(2) and the *Act* as a whole. The *Act* addresses surplus stripping with many provisions, including section 245.

c. Dr. MacDonald was a Canadian resident at the time the deemed dividends were received.

[35] Except subparagraph b(i) above, which needs no elaboration, I will elaborate, albeit somewhat summarily, on Respondent's arguments supporting these submissions.

The requirements of subsection 84(2) are met:

- The appropriation was made on winding-up or discontinuance of PC's business. That is, Dr. MacDonald was winding-up his Canadian medical practice, which was run through PC. The Respondent also submits that the appropriation was made on a reorganization of PC's business: that is, PC was reorganized from being a professional corporation to being a holding company.

- *RMM Canadian Enterprises Inc. v. R.*[16] is relied on. In particular reliance is placed on Justice Bowman's, as he then was, broad interpretation of the phrase "in any manner whatever" as used in that subsection. Addressing Dr. MacDonald's submission that the funds were received as a creditor, the Respondent emphasizes a passage in *RMM* where Justice Bowman said the share sale and winding-up of Equilease's business complement each other. "The sale was merely an aspect of the transaction described in subsection 84(2) that gives rise to the deemed dividend."[17] This is to say that the status of creditor is inextricably bound to the distribution *qua* shareholder.

- Having abandoned the sham argument as the basis for the assessment, it might have been difficult for the Respondent to argue that the transactions undertaken and effected did not give rise to J.S. having legal and beneficial ownership in the shares of PC at the time he transferred them to 601 Ltd.. Nonetheless, Respondent's counsel has, in effect, made that argument. Further, with respect to subsection 84(2), the Respondent's counsel argued that PC had effectively wound-up or discontinued its business prior to the time of the appropriation of its assets to the benefit of the Appellant so that the other requirements of subsection 84(2) were met.

Section 245 – no *bona fide* purpose for the share sale:

- The Respondent relies on there being no business purpose to the transactions.

- The avoidance of double taxation is said not to be of relevance to the GAAR analysis. Reliance is placed on *RMM*. In *RMM*, Justice Bowman said the primary purpose of a transaction must be determined in the context of Canadian tax law, and international implications were not to be considered.

Section 245 - there was a misuse or abuse of subsection 84(2) and the *Act* as a whole:

- The Respondent submits that the rationale of section 84 is to prevent a corporation from converting a taxable dividend into a capital gain. The

[16] 97 DTC 302.

[17] At page 307.

Respondent sets out a history of "surplus stripping", including its origin in the pre-1972 *Act*. There is a significant discussion on former subsection 247(1). Citing a Department of Finance technical note, the Respondent submits tax applies when extracting the funds from an entity in excess of the amount invested. When GAAR was introduced and subsection 247(1) repealed, transactions covered by subsection 247(1) were intended to be covered by GAAR.

- The Respondent submits the courts have agreed avoidance is inappropriate in the case of non-arm's length transactions resulting in "extraction of corporate funds by 'manufacturing' a capital gain eligible for the deduction provided by section 110.6 of the *Act*".[18] Four cases are cited in support.[19] In particular, Justice Bowman's comments in *RMM* regarding surplus stripping as an abuse of the *Act* as a whole are cited.

- The Respondent submits the relevant time to tax deemed dividends is when they are earned, not withdrawn from a bank account. Citing Interpretation Bulletin IT-221R3,[20] the Respondent submits Dr. MacDonald was a Canadian resident until some time after Dr. MacDonald entered the United States. The reasons for this are:

    - Dr. MacDonald signed the agreements before he left Canada;

    - The agreements acknowledge Dr. MacDonald's Canadian residency;

    - Dr. MacDonald signed the US Customs declarations as a US non-resident;

    - Dr. MacDonald maintained Canadian bank accounts, his New Brunswick driver's license, and his vehicles' New Brunswick registration after June 25, 2002.

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[18] The Respondent also includes gains protected by treaty exemptions.

[19] *McNichol v. R.*, 97 DTC 111 (T.C.C. (General Procedure)) [*McNichol*]; *RMM, supra*; *Nadeau v. R.*, 99 DTC 324 (T.C.C. (Informal Procedure)); *Desmarais v. R.*, 2006 TCC 44 (General Procedure).

[20] Canada Revenue Agency, Interpretation Bulletin IT-221R3, "Determination of an Individual's Residence Status" (4 October 2002).

- In the alternative, the Respondent submits the earliest Dr. MacDonald's residency could terminate was when he crossed the border. The dividends would still be earned before he crossed the border. This was the Appellant's filing position. He intended that his residence be fixed in Canada at least until he crossed the border. It can be said that his attention to the details of his move support and ensure that result. In effect, the argument is that the evidence is not clear enough to rebut the Respondent's presumption of the Appellant's residence in Canada at the relevant times.

- No cases on the residency issues were submitted. Regarding a Canada Revenue Agency ("CRA") letter saying Dr. MacDonald was a non-resident as of June 25, 2002, the Respondent submits that the CRA has since done a more detailed review and as a result changed its opinion. Citing *Ludco v. R.,*[21] the Respondent submits the letter is not binding on the CRA.

[36] More generally, the Respondent's argument inherently suggests that subsection 84(2) should be applied whenever a shareholder accesses retained earnings, directly or indirectly, to ensure the receipt is characterized as a dividend. That is asserted to be its intended purpose. That is, the Respondent wants subsection 84(2) to be applied to ensure dividend treatment as it was intended to apply and thereby frustrate the asserted abusive purpose of the taxpayer in this case. That will focus my analysis of subsection 84(2) in terms of its intended scope and purpose as an avoidance provision. Failing my finding that subsection 84(2) applies here, the Respondent turns to section 245. Applying GAAR, the Respondent would ensure the amount the Appellant received from PC is found to be a dividend received by him as a shareholder while resident in Canada.

<u>Appellant's Submissions</u>

[37] The Appellant's submissions can be dealt with under the section headings of the two provisions that are at issue, namely subsection 84(2) and section 245. The alternative argument respecting the residence of the Appellant will be addressed under the residence heading.

Subsection 84(2):

[21] (1993), [1994] 1 C.T.C. 368 (F.C.T.D.), rev'd on other grounds (1994), [1996] 3 C.T.C. 74 (F.C.A.).

- The Appellant's argument is that at the time of the distribution or appropriation of PC assets he was not a shareholder. Citing *Maccala v. The Queen*[22] as authority, he asserts that subsection 84(2) cannot apply in his case because at the time of the appropriation or distribution he was a creditor of the corporation, not a shareholder. The distribution here was to the shareholder of record – namely, 601 Ltd. not the Appellant.

- As well, if there was a benefit conferred on him *qua* shareholder it was not a benefit conferred on the winding-up or discontinuance of PC's business since its activities in respect of that business, such as dealing with receivables continued after the appropriation that benefited him.

- The Appellant also relies on the fact the transactions were carried out at fair market values. The provisions of section 69 of the *Act* have no relevance; and there were no benefits that accrued to him in the course of carrying out the subject transactions by virtue of his non-arm's length relationship with J.S.

Section 245:

- The Appellant asserts that there was no tax benefit in this case as the transactions were motivated to avoid a US tax by creating a capital gain in Canada prior to his departure to the US.

- Citing *Evans v. R.*,[23] he submits that there is no avoidance transaction. It is submitted that the Minister of National Revenue (the "Minister") ought not to be able to re-characterize transactions that are permitted by the *Act* as a means identifying tax avoidance.

- The Appellant further asserts that the transactions were not abusive. They did not frustrate a specific provision that the *Act* sought to prevent the outcome achieved; nor did they misuse any provision of the *Act*, defeat the object, spirit or purpose of any of the *Act's* provisions or abuse any provision having regard to the *Act* read as a whole.

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[22] 95 DTC 398 (TCC).

[23] 2005 TCC 684 (General Procedure).

- A Senate debate and a House of Commons debate were cited to reflect the parliamentary intention to relieve double taxation. As well, the use of accrued capital losses to shelter capital gains was clearly relief contemplated by the *Act*.

- More broadly put, the Appellant argues that it is not a misuse or abuse of the provisions of the *Act* to engage in a transaction that allows for the utilization of genuine historical losses. Further, it is asserted that if it is found on the facts of this case that the purpose of the transactions was to re-characterize income, the *bona fide* primary purpose of same was not to enjoy the tax benefit of utilizing available capital losses and loss carry forwards but was to avoid double tax that would arise given the deemed disposition rules in Canada and the failure of the US taxing provisions at the time to recognize the stepped-up cost base in the shares of PC.

  The Appellant's Residence:

- As an alternative argument the Appellant asks me to consider that he was not a resident of Canada, at the relevant time, should I find that the alleged distribution or appropriation must be treated as a dividend.

- It is asserted that this alternative would result in the *Act* imposing only a withholding tax on the dividend at a rate of 15% or even 5% depending on the application of the provisions of the Canada – United States Treaty.[24]

<u>Analysis</u>

Subsection 84(2)

[38] Subsection 84(2) reads:

> **84(2) Distribution on winding-up, etc.** -- Where funds or property of a corporation resident in Canada have at any time after March 31, 1977 been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares in its capital stock, on the winding-up, discontinuance or reorganization of its business, the corporation shall be deemed to have paid at that time a dividend on the shares of that class equal to the amount, if any, by which,

[24] See Canada-U.S. Tax Treaty, Art. X.

> (a) the amount or value of the funds or property distributed or appropriated, as the case may be,
>
> exceeds
>
> (b) the amount, if any, by which the paid-up capital in respect of the shares of that class is reduced on the distribution or appropriation, as the case may be,
>
> and a dividend shall be deemed to have been received at that time by each person who held any of the issued shares at that time equal to that proportion of the amount of the excess that the number of the shares of that class held by the person immediately before that time is of the number of the issued shares of that class outstanding immediately before that time.

[39] The property that the Appellant received, at least at the beginning of the chain of events, is a promissory note – the J.S. note. That is not PC property.

[40] Following the series of events, the Appellant received payment of the J.S. note as a creditor of PC and he was paid as such with funds from PC.

[41] The Respondent wants me to find then that the Appellant has received those funds from PC in the capacity of a shareholder.

[42] On the other hand, the Respondent has conceded that each transaction in the series leading to the Appellant receiving PC funds was a legally effective transaction creating genuine liabilities among all the parties involved in the series.

[43] The distribution of PC funds as a dividend paid to 601 Ltd. as its sole shareholder was then a legally effective dividend.[25] The transactions that followed that resulted in the Appellant being a creditor of PC were also legally effective transactions. Therefore, at law, there really should be no dispute that the Appellant received the PC funds *qua* creditor.

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[25] It may be somewhat confusing to appreciate the timing issues presented by these facts. In the context of capital gains treatment, the relevant time to calculate the gain is the time of the share sale which here corresponds to the time of the delivery of the J.S. note. The assessment at issue applies the same timing approach to the application of subsection 84(2) and GAAR regardless of when dividends were actually paid. Had the actual dividends been considered relevant, the September dividend would have been subject to Part XIII tax. In my analysis the actual dividends are relevant but not in a way that invokes Part XIII. The actual dividend confirms the manner by which PC funds were distributed to the relevant shareholder at the relevant time for the purposes of subsection 84(2).

[44] My reference to the series of “legally effective transactions” derives from the abandonment of the assessing position that the subject transactions were a sham. That being the case, I have concluded, on the facts of this case, that the subject transactions were legally effective, giving rise to the rights and liabilities created by the terms of those transactions.

[45] Put another way, it is my view that any entitlement that the Appellant arises as consideration from the share sale. That is not an entitlement *vis-à-vis* the Appellant and PC. That is, the right to receive $525,068 is not an entitlement *vis-à-vis* the Appellant and the company.

[46] That being the case, subsection 84(2), on its express terms, cannot apply to deem a dividend to the Appellant in this case.

[47] Still, the Respondent essentially makes three arguments. First, reliance is placed on the phrase “in any manner whatever”. Second, reliance is placed on *RMM*. Third, reliance is placed on a purposive rather than literal construction of the subject provision. This third argument led to the argument that subsection 84(2) was an anti-avoidance provision that, more specifically, dealt with what has been commonly referred to as surplus stripping. In answer to this aspect of the Respondent’s argument, the Appellant referred the Court to a related CRA advance income tax rulings dealing with surplus strip transactions in a post-mortem context. I will deal with that as an adjunct to the Respondent’s third argument.

[48] As to the Respondent’s reliance on the phrase “in any manner whatever”, such reliance is, in my view, ill-fated. The manner of distribution of PC property in this case was a dividend. The party benefiting from that distribution was the shareholder, 601 Ltd.. The express language of “in any manner whatever” does not redirect to whom the dividend was paid. It is the manner of effecting the distribution to the shareholder at the time of that distribution that the subject provision is aimed. Any manner of distribution to 601 Ltd. other than as a dividend would, pursuant to subsection 84(2), result in 601 Ltd. being deemed to have received a dividend (whether or not that invokes a tax consequence to that shareholder at that time).

[49] The entitlement of the Appellant derives from his being a creditor of the third party purchaser. Compare the language in subsection 84(2) with that in subsection 84(3). The latter provision addresses an acquisition of shares and deems a dividend to the extent the amount paid for the shares acquired exceeds the paid-up capital of those shares. While that provision deals only with the acquisition by a company of its own capital stock, it confirms that a provision dealing more broadly

with amounts paid for shares acquired could have expressly been subject to a similar formulation of the deemed dividend component where the company directly or indirectly financed the payment of the purchase price. That subsection 84(2) has no such express language, demonstrates to me that its scope was not intended to cover payments arising as consideration on a share sale.

[50] Indeed, as I have already said, the express language of subsection 84(2) ensures that it is only a shareholder at the time of the distribution or appropriation who can be deemed to be the recipient of a dividend. That language, set out again with emphasis, is:

> Where funds or property of a corporation … have … been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders … on the winding-up, discontinuance or reorganization of its business, the corporation shall be deemed to have paid *at that time* a dividend on the shares of that class equal to … and *a dividend shall be deemed to have been received at that time by each person who held any of the issued shares at that time* equal to … [Emphasis added].

[51] Such language does not permit a finding in this case that it can apply to deem the share sale price paid to the Appellant to be a dividend.

[52] Further, the Appellant's ongoing management of PC's affairs does not speak at all to the capacity in which he received his entitlement to PC's assets. It does not establish a beneficial ownership in PC shares that differed from the legal ownership. 601 Ltd. held both legal and beneficial ownership in the PC shares. That 601 Ltd. was holding shares in a company that had liquid assets equal in value to its liabilities, and that it acquiesced to or agreed to leave the sole creditor of the company at its helm as the sole officer and director, do not in themselves trigger principles of law that would convert the creditor to the status of shareholder.

[53] In any event, the Respondent raised no such principles of law that suggest such a leap. For example, no argument of an agency or trust arrangement existing was made. If such argument had been made, it would have been rejected. At best, in the absence of saying the transfer of legal ownership was artificial or a sham, the material contractual trail here is the one attaching to the funds. Even if it could be said, following that trail, that the distributions received by 601 Ltd. were held for the indirect benefit of the Appellant, his entitlement would still be *qua* creditor. At that point in time he was a creditor of J.S., who was a creditor of 601 Ltd.. That 601 Ltd. might be said to have assumed J.S.'s obligation to the Appellant in satisfaction of its debt to J.S. does not alter the fact that the Appellant's entitlement is *qua* creditor.

[54] That takes me to the Respondent's second argument, which was reliance on *RMM*. It is the principle authority relied on by the Crown for the position that I should recognize the Appellant as the recipient of PC property *qua* shareholder for the purposes of subsection 84(2). A passage in *RMM* was cited where Justice Bowman, as he then was, said the share sale and winding-up of a business complemented each other. "The sale was merely an aspect of the transaction described in subsection 84(2) that gives rise to the deemed dividend."[26] This was to say that the status of creditor was inextricably bound to the distribution *qua* shareholder.

[55] I am not persuaded that the distinction between a shareholder and a creditor can be ignored in this case. It is true, in the case at bar, that the share sale and the liquidating distributions contemplated each other, and that via a friendly intermediate buyer, corporate funds ended up in the hands of a "former" shareholder, namely the Appellant. In *RMM*, a buyer of shares was also introduced as a convenient intermediary to allow the value of the acquired company to end up in the hands of the former shareholder, thereby, in that case, avoiding Canadian withholding tax. It is true then that the facts in *RMM* are not easily distinguished from the case at bar other than the assessing target in *RMM* was the avoidance of Canadian withholding taxes which is not the target the Respondent has aimed at in the case at bar.

[56] However, *RMM* stands in contrast to *McNichol v. The Queen*.[27] In *McNichol*, Justice Bonner came to a different conclusion on subsection 84(2): the sale of shares of a corporation with cash as its only asset did not trigger subsection 84(2) even though the purpose of the sale was to permit the share vendor to access the capital gains exemption instead of a dividend.

[57] In that case, much like the one at bar, a compliant corporate buyer (that later amalgamated with the corporation) was used, although the corporate funds used to pay the share vendors their proceeds of disposition was borrowed money. Ultimately, the purchasing intermediary used the corporation's cash to pay off the loan it incurred to fund the share purchase. Justice Bonner applied the language of

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[26] *RMM*, *supra* at 307.

[27] *Supra*.

subsection 84(2) strictly in finding that it did not apply although he held against the taxpayers under GAAR.

[58] In *RMM*, Justice Bowman distinguished *McNichol.*[28] The distinction made by Justice Bowman appears to be based on the blatant or transparent use of the intermediary in *RMM*. One might argue that the *McNichol* transactions were similarly blatant and transparent.

[59] With the greatest respect then, I do not agree that the distinctions drawn in *RMM* ought to limit the scope of the decision in *McNichol*. In my view, the *McNichol* approach which was to look to section 245 when subsection 84(2) does not apply on a strict construction of its language, is the correct approach. I will expand on that view momentarily in my discussion of surplus stripping which is at the heart of what I have referred to as the Respondent's third argument and again in my discussion of that topic in the GAAR analysis that follows.

[60] First, I note that there is another aspect of *McNichol* that warrants mention. It is true that the agreement to sell the shares of PC in the case at bar must have contemplated the use of corporate funds as a means to finance the purchase. The vendor shareholder, while still a shareholder, had the benefit of knowing that the series of transactions following the sale were being structured to do just that. That was also the case in *McNichol* where it was understood by all involved that the post-share sale events were going to be undertaken. Still, Justice Bonner did not consider that knowledge as an obligation to undertake those events.

[61] In any event, it is not the promise or foreseeability of a benefit while a shareholder that triggers the operation of subsection 84(2). The requirement of that provision is that there be a distribution or appropriation in any manner whatever for the benefit of a person who is a shareholder *at the time* of that distribution or appropriation. A structure undertaken while a shareholder that ensures, by a series of transactions, access to corporate funds to satisfy a debt created as a result of ceasing to be a shareholder, is not the same as being in receipt of such funds, or being in receipt of a benefit, *qua* shareholder.

[62] Accordingly, it remains my view that the words of subsection 84(2) do not impose a requirement to re-characterize payments to a creditor as payments to a shareholder.

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[28] *RMM, supra* at 308.

[63] That takes me to what I see as the Respondent's third argument. Inherently, by pleading for a purposive rather than literal construction of subsection 84(2), the Respondent asserts an abuse of the *Act* in this case broader than one that relates to the interaction of capital gains and capital losses in the calculation of income and taxable income. As stated earlier in these Reasons, referring to paragraph 18 of the Reply, the broader concern is the avoidance of the ordinary consequences of distributions of corporate assets, as dividends, that are meant to arise on a wind-up or discontinuance of business. More specifically it is a concern, not so much as to a particular tax benefit that might arise from the tax difference between shareholders accessing retained earnings as a dividend versus receiving capital gains treatment, it is a concern stemming from a view that the purpose of subsection 84(2), as it was brought in by legislation affecting post-1971 dispositions of capital property, was to prevent capital gains treatment. The suggestion is that it was, and remains, an anti-avoidance provision the language of which must be construed more broadly to ensure dividend treatment when a taxpayer indirectly receives the retained earnings of a company that he was entitled to receive as a shareholder.

[64] In my view, that suggestion is tenuous. It is even more of a leap to suggest that the post-1971 provision, following the former model, was intended to ensure the post-1971 restrictions on the use of capital losses when neither such losses nor such restrictions existed in the pre-1972 *Act*. In fact, the historical references relied on by the Respondent underline that this third argument is all about an attack on surplus stripping transactions *per se*.

[65] This strikes me as a GAAR issue, however before taking the analysis there, the Respondent's suggestion that this rationale to 84(2) dictates against a literal construction of that provision, requires more to be said about surplus stripping in the context of that provision.

[66] In my view, there is nothing in the language of subsection 84(2) that warrants a finding of a rationale other than liquidating distributions out of a corporation's earnings *to its shareholders* - holding a particular class of shares - are to be treated as dividends to the extent the distribution exceeds the paid-up capital of the particular class of *shares held* by persons receiving the distribution. That rationale formulation is set out in paragraphs 84(2)(*a*) and (*b*). More generally, that rationale is part of a consistent theme that retained earning of a corporation are a source of dividends and their use or withdrawal for the benefit of shareholders should not be subject to different tax treatment than applicable to dividends.[29]

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[29] Sections 15 and 84 being the most obvious examples of the specified situations to which I refer.

[67] That said, it is dubious whether subsection 84(2) was ever an anti-avoidance provision in the sense of ensuring this result in the case of a so-called surplus strip which is what the Appellant's tax plan accomplished. The surplus strip here was having the Appellant's shares acquired with corporate funds funnelled through a related corporation as a tax-free dividend. This classic strip in the old system was subject to a specific anti-avoidance provision; namely section 138A of the old, pre-1972 *Act*. That provision was replaced in 1972 with section 247 which was repealed in 1988. The section that survived is, of course, section 245. That is the provision to look at in these circumstances. Essentially that is what Justice Bonner concluded in *McNichol* and I agree.

[68] In coming to this conclusion, I cannot ignore the Supreme Court of Canada decision in *Smythe et al. v. Minister of National Revenue*[30] even though the parties made no direct reference to it. In that case, the Crown was successful in applying the subsection 81(1) of the pre-1972 *Act* (the predecessor to subsection 84(2)) to a dividend strip. While the Supreme Court of Canada found it unnecessary to express any opinion on the scope of subsection 137(2) of the pre-1972 *Act* as a condition of applying the former section 81(1), it is interesting to note that the Exchequer Court did rely on that former provision as an anti-dividend stripping provision. Subsection 137(2) was an artificial transactions provision. If a transaction artificially conferred a benefit, the benefit was deemed to have been conferred "notwithstanding the form or legal effect of the transactions". The Supreme Court of Canada just relied on the artificiality of the transaction that gave rise to the dividend strip without reliance on the former subsection 137(2). In the case at bar, no assertion was made that the subject transactions were artificial. Furthermore, and importantly, as noted earlier in these Reasons, former subsection 137(2) was replaced in the post-1971 *Act* by the former section 247 which became the current section 245 in 1988.[31] All this is to say that the appropriate provision to apply in

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[30] [1970] S.C.R. 64.

[31] Interestingly, Justice Bonner in *McNichol* distinguished *Smythe* on the basis that the McNichol transactions could not be described as artificial. The similarity of the transactions in *McNichol* with transactions in the case at bar might suggest that the Respondent might not have been successful even if the Respondent had taken the position that subject series of transactions were artificial although in that case *RMM* (which also referred to *Smythe*) might arguably have carried more weight.

the case at bar given the withdrawal of the sham basis for the subject assessment, in my view, is section 245 of the *Act*.

[69] Accordingly, I see no basis to find that a purposive contextual analysis of subsection 84(2) would invite a less literal interpretation of its language than that I have found must govern, although there remains one last aspect of this argument that needs to be addressed.

[70] I noted above that there is another aspect of the Minister's anti-surplus stripping position that needs to be addressed. It was raised by Appellant's counsel who referred me to what was suggested to be an analogous tax planned surplus strip strategy where the CRA had issued advance income tax rulings. I will refer to this strategy momentarily as post-mortem pipeline tax plans.

[71] Needless to say CRA's ruling practices normally carry little weight in this Court's determination of how the language of any provision of the *Act* must be interpreted and applied. However, CRA's practices in respect of surplus stripping tax planning strategies in another context, does tend to underline the difficulty of administering subsection 84(2) where abuse is not the sole focus of the analysis.

[72] The context in respect of which the subject ruling practices on surplus strips is relevant is the avoidance of double taxation on death. Post-mortem tax plans typically seek to avoid double taxation by ensuring or preserving either dividend treatment or capital treatment to an estate in respect of the distribution of funds to an estate from a company owned by the deceased at death.

[73] Double taxation results from the deemed disposition of capital assets on death, which could trigger a capital gain on shares held by the deceased at death, and a subsequent taxable dividend - or deemed dividend under subsection 84(2) - on the distribution of corporate funds to the estate. That distribution diminishes the value of the shares and creates a capital loss for the estate on the retirement of the shares inherited at a high adjusted cost base (*acb)* as result of the deceased's deemed disposition at fair market value (*fmv*).[32] If this liquidation of the company is done in the first year following death, the estate's capital loss can be carried back to the deceased's year of death, wiping out the capital gain that arose from the deemed disposition pursuant to subsection 164(6). This avoids double tax in the sense that the retained earnings of the company have only been taxed once as a

[32] The deceased taxpayer disposes of his shares at *fmv* under paragraph 70(5)(*a*), and the estate acquires them at *fmv* under paragraph 70(5)(*b*).

dividend to the estate. What is most important here is that it also illustrates that the *Act*, in this case at least, is not preoccupied with the difference between capital gains treatment and dividend treatment. That is, dividend treatment, fully integrated or not, is acceptable.

[74] While it can be argued that this is an exceptional circumstance, it is not so much exceptional in allowing the capital gain to be converted to dividend treatment. It is exceptional in allowing a capital loss to be transferred to a different taxpayer in a different taxation year. In any other circumstance it would likely trigger GAAR if accomplished by way of an avoidance transaction.

[75] Even if it is exceptional in allowing the capital gain to be converted to dividend treatment, it does so as part of a final accounting or reconciliation of a deceased person's capital gains and losses. A similar situation exists in the context of a departure from Canada. Ensuring a similar result by an avoidance transaction does not strike me as abusive.

[76] That said, I note that the advance income tax ruling referred to by Appellant's counsel concerns the use by the estate of a newly formed holding company. The estate transfers the shares of the company that were owned by the deceased at death (the "deceased's company") to the new holding company. The consideration for the transfer is a note equal in value to the *fmv* of the transferred shares, which does not trigger a capital gain given the estate's high *acb* in the shares of the deceased's company. The deceased's company pays a liquidating dividend to the holding company, which uses the funds to pay the note held by the estate. This avoids double tax: the retained earnings of the deceased's company have only been taxed once, as a capital gain to the deceased in the year of death.

[77] This latter post-mortem plan is sometimes referred to as the post-mortem pipeline. The post-mortem pipeline, like the case at bar, attempts to avoid dividend treatment by employing steps that ensure that the tax planner receives the liquidating dividend *qua* creditor. The choice is made to accept capital gains treatment on death as opposed to dividend treatment on the estate's receipt of corporate assets.

[78] The CRA has issued advance income tax rulings that such post-mortem pipeline transactions will not be subject to subsection 84(2) if the liquidating

distribution does not take place within one year and the deceased's company continues to carry on its pre-death activities during that period.[33]

[79] This post-mortem plan clearly parallels the Appellant's tax plan in the case at bar. Both plans provide access to a corporation's earnings in a manner that avoids dividend treatment. As well, both situations deal with a time of reconciliation – death and departure from Canada. The conditions imposed on the post-mortem transactions, if imposed in the case at bar, would show that the CRA's assessing practice was consistent in trying to apply subsection 84(2). The message seems to be: do the strip slowly enough to pass a contrived smell test and you will be fine.

[80] This is not a satisfactory state of affairs in my view. The clearly arbitrary conditions imposed are not invited by the express language in subsection 84(2). I suggest that they are conditions imposed by the administrative need not to let go of, indeed the need to respect, the assessing practice seemingly dictated by *RMM*. Make it "look" less artificial and the threat of subsection 84(2) disappears. This unsatisfactory state of affairs more properly disappears once it is accepted that subsection 84(2) must be read more literally in all cases and GAAR applied in cases of abuse.

[81] The analysis in *Canada Trustco Mortgage Co. v. Canada*[34] fits nicely in support of this overall approach:

> 11 … the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation. Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.
>
> 12 The provisions of the *Income Tax Act* must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently. As stated at para. 45 of *Shell Canada Ltd. v. R.*, [1999] 3 S.C.R. 622 (S.C.C.):
>
> > <u>[A]bsent a specific provision to the contrary</u>, 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

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[33] See rulings 2002-0154223 and 2005-0142111R3. Reference might also be made to TI 2006-0170641E5 and a round table discussion published in *Congrès 2009* (Montreal: Association de Planification Fiscale et Financières, 2010) vol. 2 at 47:35-38, with the English translation found in CRA document no. 2009-0326961C6.

[34] [2005] 2 S.C.R. 601.

> Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. [Emphasis added.]

> See also *65302 British Columbia*, at para. 51, *per* Iacobucci J. citing P. W. Hogg and J. E. Magee, *Principles of Canadian Income Tax Law* (2nd ed. 1997), at pp. 475-76:
>
> > It would introduce intolerable uncertainty into the Income Tax Act if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and purpose of the provision.
>
> 13 The *Income Tax Act* remains an instrument dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation. Onto this compendium of detailed stipulations, Parliament has engrafted quite a different sort of provision, the GAAR. This is a broadly drafted provision, intended to negate arrangements that would be permissible under a literal interpretation of other provisions of the *Income Tax Act*, on the basis that they amount to abusive tax avoidance. To the extent that the GAAR constitutes a "provision to the contrary" as discussed in *Shell* (at para. 45), the Duke of Westminster principle and the emphasis on textual interpretation may be attenuated. Ultimately, as affirmed in *Shell*, "[t]he courts' role is to interpret and apply the Act as it was adopted by Parliament" (para. 45). The court must to the extent possible contemporaneously give effect to both the GAAR and the other provisions of the *Income Tax Act* relevant to a particular transaction.

[82] This strikes me as the appropriate approach in this case. In the circumstances of this case, there is nothing in subsection 84(2) of the *Act* that invites the CRA or this Court to change either who the recipient of a benefit is, or the legal status or capacity of the recipient. To re-characterize or ignore the Appellant's legal status in this case invites consideration of the application of section 245 of the *Act*. Subsection 245(5) allows just that in certain circumstances. In those circumstances, and only in those circumstances, should the subject transactions be re-characterized. Put another way, where GAAR would not apply to re-characterize the legal effect of a series of transactions, other provisions of the *Act* should not be too readily stretched to give that result where a strict reading of them does not invite such result. This is simply a re-statement of a principle set out by the Supreme Court of Canada in *Canada Trustco*:

> 16 … The GAAR's purpose is to deny the tax benefits of certain arrangements that comply with a literal interpretation of the provisions of the Act, but amount to an abuse of the provisions of the Act. …

[83] I add here that reading further in these Reasons, the parties will learn that even applying GAAR, the Appellant is successful. In fact, this may well be described as a case where it benefited the taxpayer to seek refuge in GAAR. Uncertainties in the application of another provision of the *Act,* such as subsection 84(2), to a particular avoidance scheme might be resolved by looking at GAAR at least where the application of GAAR reinforces the construction of the other provision advanced by the taxpayer in a particular case. In such cases, GAAR might be viewed as a shield. That the authorities demand that it not be used as a further sword where another has failed to strike down a taxpayer,[35] does not suggest the possibility that in some cases it can be used as a shield in the sense of being a better litmus test to apply to prevent improper avoidance as opposed to looking to expand the scope of a carefully worded provision like subsection 84(2).

[84] As to the Appellant's argument that the business of PC had not been wound–up, I do not agree. "On the winding-up" as used in subsection 84(2) refers to a course of events that are part of the winding-up process. There is no question in my mind that the distributions at issue in this case were in the course of winding-up PC's business.

[85] Even if that were not the case there was at least a reorganization of PC's business. It went from carrying on a medical business that fed its investment activities to a holding vehicle.[36] However, even the holding function existed only to effect the total distribution of its assets. Viewed as a whole, the distributions here were clearly part of a winding-up process and were made then "on the winding-up" for the purposes of subsection 84(2).

[86] Nonetheless, for the reasons set out above, subsection 84(2) does not apply in this case.

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[35] In *Geransky v. R.*, 2001 DTC 243, Bowman J. as he then was said where a taxpayer avoids specific anti-avoidance provisions, the Minister cannot subsequently use GAAR to fill uncovered gaps in the *Act*. This approach was confirmed post-*Canada Trustco* in *Landrus v. R.*, 2008 TCC 274, aff'd 2009 FCA 113. See also *Collins & Aikman Products Co. et. al. v. R.*, 2009 TCC 299 at para. 109.

[36] Considering the predecessor provision to 84(2) in *Kennedy v. M.N.R.*, 72 DTC 6357 (F.C.T.D.), Cattanach J. said the words "winding-up" and "discontinuance" contain an "element of finality". It was therefore logical to assume "reorganization" meant the conclusion of the business in one form and its continuance in another. See also *McMullen v. R.*, 2007 TCC 16 at paras. 18-20.

Section 245

[87] The charging provision in section 245 is found in subsection 245(2):

> **245(2) General anti-avoidance provision [GAAR]** -- Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

[88] The terms "tax avoidance" and "tax benefit" are defined in section 245 and even where such requirements of this charging provision are met, there are exceptions to its operation set out in subsection 245(4).

[89] The overall manner of dealing with the application of these components of section 245 was laid out by the Supreme Court of Canada in *Canada Trustco*, and summarized in *Copthorne Holdings Ltd. v. R.*,[37] as follows:

> 1. Was there a tax benefit?
>
> 2. Was the transaction giving rise to the tax benefit an avoidance transaction?
>
> 3. Was the avoidance transaction giving rise to the tax benefit abusive?

Was there a tax benefit?

[90] "Tax benefit" is a defined term in subsection 245(1):

> **(1) Definitions** -- In this section,
>
> "tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty;

[91] It is interesting to note that the definition of a "tax benefit" does not expressly address whether the benefit was one to which the taxpayer would have been entitled even if the transactions that gave rise to it had not been carried out.

[37] 2011 SCC 63.

On the other hand, that comparables might be relevant in a case like this was noted by the Supreme Court of Canada in *Canada Trustco* and reiterated in *Copthorne* at paragraph 35:

> As found in *Trustco*, the existence of a tax benefit can be established by comparison of the taxpayer's situation with an alternative arrangement (para. 20). If a comparison approach is used, the alternative arrangement must be one that "might reasonably have been carried out but for the existence of the tax benefit" (D. G. Duff, et al., *Canadian Income Tax Law* (3rd ed. 2009), at p. 187). By considering what a corporation would have done if it did not stand to gain from the tax benefit, this test attempts to isolate the effect of the tax benefit from the non-tax purpose of the taxpayer.

[92] By reporting the consideration received from J.S. as a capital gain rather than as a dividend from PC, the Appellant was able to use net capital losses on hand to off-set the gain. Aside from the Respondent's underlying concern over surplus strips and the avoidance of dividend treatment on the wind-up of a business, the use of capital losses is the only actual tax benefit that the Respondent has identified. If a comparison approach is used, we would ask: what would likely have been done but for the purpose of deriving this benefit?

[93] My answer might well be that the Appellant would have left Canada a shareholder of PC. In that case, he would have the very tax benefit that his impugned arrangement gave rise to which is to say, comparatively, there is no tax benefit at all. That is, if the Appellant moved to the United States still holding his shares in PC, he would have had the benefit of the use of the subject losses simply by virtue of the deemed disposition provision referred to earlier in these Reasons.

[94] Logically then, one could conclude that there is no tax benefit here or at least not the tax benefit relied on by the Respondent as relevant. On the other hand, the Respondent did not rely on a comparative approach to identifying the tax benefit in this case.

[95] I have no doubt that the assessment can proceed without reliance on a comparison. This is made clear in *Canada Trustco*. At paragraphs 19 and 20 the Court found as follows:

> 19 … Whether a tax benefit exists is a factual determination, initially by the Minister and on review by the courts, usually the Tax Court. …
>
> 20 If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. In some other

> instances, it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement. …..

[96] While the Court goes on in that paragraph 20 to include the case of the benefit of a capital gain versus business income in examples of cases where a comparable might be used, I do not find that to be sufficient to force the analysis in this case beyond accepting the simple and clear tax benefit identified by the Respondent; namely, the creation of a capital gain enabling the use of capital losses which resulted in a reduction of tax payable.

[97] Further, I note that looking beyond *that* clear tax benefit identified by the Respondent, would not be consistent with the analytical approach set out in *Canada Trustco* and left undisturbed in *Copthorne*.

[98] At paragraph 63 of *Canada Trustco* under the heading "Burden of Proof" the Court noted:

> The determination of the existence of a tax benefit and an avoidance transaction under s. 245(1), (2) and (3) involves factual decisions. As such, the burden of proof is the same as in any tax proceeding where the taxpayer disputes the Minister's assessment and its underlying assumptions of facts. The initial obligation is on the taxpayer to "refute" or challenge the Minister's factual assumptions by contesting the existence of a tax benefit …

[99] This requires that the Minister's assumptions be sufficient to identify a particular tax benefit that is the focus of the section 245 analysis. That is, I do not accept this reference to the taxpayer's burden to refute the existence of a tax benefit as relieving the Minister of the responsibility to identify with certainty the tax benefit that the avoidance transactions have given rise to and that are asserted to be abusive. There should be no doubt about what it is that the Appellant has to rebut. There is a burden on the Minister in this regard.

[100] However, at this point I must also note that the selective identification of one particular tax benefit as opposed to another has an element of arbitrariness that is somewhat unsettling in this case. It was clearly open for the Minister to assess the subject transactions on the basis that the tax benefit was the elimination of Part XIII tax.

[101] Reliance could readily have been made on the comparable of the Appellant moving to the United States without engaging in the share sale, using his capital losses, then winding up PC after the move. In effect, that is the result that the

Appellant is willing to accept in his alternative argument. However, that comparable is not the subject of this appeal. The Minister accepted that the impugned transactions were effectively completed, as planned, by a resident of Canada. Still, as I have suggested before, I am not satisfied that my analysis will be complete if all I do is focus on the tax benefit relied upon by the Minister in this case. The GAAR analysis will only be complete, in my view, if I address the Respondent's underlying concern in this appeal head-on, namely the issue of surplus stripping *per se*. I will deal with that concern, under a separate "abuse" heading where I have concluded that it is doubtful whether in an integrated corporate/shareholder tax system, a surplus strip *per se* can be said to abuse the spirit and object of the *Act* read as a whole.

[102] That aside, it is clear that the proper focus of the GAAR analysis must be on the particular tax benefit that the Minister relied on as having arisen as a result of the subject surplus strip, namely the utilization of the Appellant's net capital losses.

[103] That was the benefit afforded by the strip and under GAAR it is that benefit that is of pivotal relevance.

[104] Consider the following passage from *Canada Trustco*:

> 64 … The Federal Court of Appeal (in *OSFC*) held that there is no burden on either party at the stage of interpreting the provisions at issue, since this is a question of law, which is ultimately for the court to decide. It went on to state at para. 68 that "from a practical perspective, … [t]he Minister should set out the policy with reference to the provisions of the Act or extrinsic aids upon which he relies".
>
> 65 For practical purposes, the last statement is the important one. The taxpayer, once he or she has shown compliance with the wording of a provision, should not be required to disprove that he or she has thereby violated the object, spirit or purpose of the provision. It is for the Minister who seeks to rely on the GAAR to identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated, when the provisions of the Act are interpreted in a textual, contextual and purposive manner. The Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.

[105] The object and spirit of a particular provision of the *Act* can only be said to have been abused in relation to affording a particular unintended tax benefit. The

issue here is then about the objectives and policies of the *Act* that relate to the limited use of capital losses, not about some general theme concerning access to corporate retained earnings other than as a dividend. That is, the asserted unintended tax benefit created by the strip - the use of capital losses - should be the focus of the analysis.

[106] Accordingly, I will proceed on that basis.

Was the transaction giving rise to the tax benefit an avoidance transaction?

[107] GAAR can only apply where there is an avoidance transaction, as defined in subsection 245(3):

> **245(3) Avoidance transaction** -- An avoidance transaction means any transaction
>
> (a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or
>
> (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

[108] It is well established that: "an avoidance transaction may operate alone to produce a tax benefit, or may operate as part of a series of transactions which produces a tax benefit."[38]

[109] Given the "tax benefit" identified above, it is not, strictly speaking, necessary for me to consider the series of transactions here. The tax benefit was secured on the sale of the Appellant's PC shares to J.S.. However, it is fair to say that the sale of the shares here does not exist in a vacuum: each transaction, from beginning to end, was entered into and completed in contemplation of each other. The remainder of the series of transactions gave rise to other tax benefits, domestic and foreign, but they are not relevant in the context of the tax benefit under consideration in this appeal. More specifically, if I look beyond the share sale and acknowledge that the Appellant has by the series of transactions accessed PC funds as a creditor so as to avoid both Part XIII tax and double tax in the United States,

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[38] *Copthorne* at para. 39.

that does not alter the fact that the share sale *per se* was not for any other purpose than to obtain the tax benefit of utilizing his capital losses in Canada.

[110] Accepting that the share sale to J.S. gives rise to the tax benefit, it is clear the Appellant undertook *that* transaction primarily, indeed only, to obtain the tax benefit. Although that finding seems unremarkable since the use of his capital losses was assured even if he did nothing but move to the United States with his PC shares in hand, it is a transaction that resulted in the tax benefit identified by the Respondent.

[111] At the risk of being redundant, having found that the primary purpose of the share sale was to utilize capital losses, I want to make it clear that I do not accept the Appellant's evidence that the non-Canadian tax benefit of avoiding double taxation in the US was the primary purpose of the share sale. Such assertion is overly simplistic. It was a purpose that needed to be addressed in a manner that did not cause him to lose the benefit of utilizing his capital losses. To achieve *that* purpose, he determined that the share sale was required while he was a resident of Canada. The only purpose of the share sale *per se* then was, as stated, to utilize his capital loses as maintained by the Respondent. Further, even if the purpose of the series of transactions was the avoidance of a foreign tax, the effect of achieving that purpose would be to preserve the economic benefit of utilizing his Canadian capital loses. As such it would not, in my view, alter my finding that his primary purpose was preserving the benefit of utilizing his capital losses.

Was the Share Sale Abusive in Creating a Capital Gain Which Would be Off-set by Capital Losses?

[112] Subsection 245(4) can be thought of as a saving provision, ensuring GAAR does not apply to legitimate tax minimization transactions:

> 245(4) **Application of subsec. (2) --** Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction
>
> (a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of
>
> (i) this Act,
> (ii) the *Income Tax Regulations*,
> (iii) the *Income Tax Application Rules*,
> (iv) a tax treaty, or

> (v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or
>
> (b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.

[113] The analysis of this issue was framed by Chief Justice McLachlin and Justice Major in *Canada Trustco*:

> The heart of the analysis under s. 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case. The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The next task is to determine whether the transaction falls within or frustrates that purpose. The overall inquiry thus involves a mixed question of fact and law. The textual, contextual and purposive interpretation of specific provisions of the Income Tax Act is essentially a question of law but the application of these provisions to the facts of a case is necessarily fact-intensive.[39]

[114] The Respondent submits that subsection 84(2) is abused by the share sale. In my view, that is an erroneous submission. While there is the question already raised and dealt with, namely the purpose of subsection 84(2) which I have concluded is not an anti-surplus stripping provision and does nothing more than deal with shareholder access to corporate funds beyond the paid-up capital of the shares held by that shareholder, what is clearer still is that subsection 84(2) cannot be said to have anything to do with a purpose in the *Act* to prevent capital losses from sheltering income other than capital gains. Indirectly, that provision may have that effect in this case, but that cannot be said to be its purpose. The provision of the *Act* that establishes that purpose is section 3. The real question then is whether section 3 of the *Act* has been abused.

[115] That is, the share sale changed the nature of a receipt funded by distributions from PC from dividend income to a capital gain, and thereby frustrated the statutory objective expressed in section 3. That section prevents using capital losses to shelter anything but capital gains and, as a starting point, suggests that it would be abusive to structure transactions in a way that defeats that objective. However, even accepting that as the case that the Appellant has to meet, notwithstanding that it was not argued quite that precisely by the Respondent, I am

[39] *Supra* at para. 44.

not satisfied that that legislative policy can be so rigidly applied considering how the *Act* as a whole tends to be permissive of various ways to use capital losses even by somewhat artificial means.

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

[117] After triggering a capital gain on a disposition one presumably can re-acquire the identical asset back and enjoy a stepped-up cost base. The capital gain realized in that case is somewhat artificial or superficial. However, there is no rule against superficial gains crystallized for no other purpose than to utilize capital losses.

[118] In the case at bar, I do not see how then the transaction creating the tax benefit can be seen as abusive. Indeed, in light of the superficial loss provisions in the *Act*, and other express loss restriction rules, one might consider the possibility, if not the likelihood, that a specific anti-avoidance rule in the case of a tax planned realization of a capital gain was rejected as a matter of policy.

[119] The *Act*'s tolerance to the utilization of genuine capital losses reflects that the *Act* is still largely based on fundamental equitable principles: it seeks to impose tax on increments in economic power which is an approach based on ability to pay. While it is true that the tax treatment for income losses and capital losses are distinct, fundamentally a capital loss can have a dramatic influence on one's ability to pay. The losses here are not artificial, they are not superficial. They are genuine and to suggest that planning one's affairs in a manner that would ensure recognition of such losses is not abusive in my view. That view is buoyed all the more considering that the plan ensured recognition of his losses without diminution by adverse foreign consequences. This is not a case like *1207192 Ontario Limited v. The Queen*[40] where Justice Paris found the loss in question did not result in a diminution of the taxpayer's economic power.

[120] The reasons not to find the use of capital losses an abuse in the case at bar are even more compelling given the mandate in the *Act* to account for capital gains

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[40] 2011 TCC 383.

and losses on a departure from Canada. That very mandate ensures taxpayers the opportunity to reconcile their tax liabilities in Canada. This is expressly provided in paragraph 128.1(4)(*b*) of the *Act*:

> **128.1(4) Emigration** -- For the purposes of this Act, where at any particular time a taxpayer ceases to be resident in Canada,
>
> …
>
> (b) **Deemed disposition** -- the taxpayer is deemed to have disposed, at the time (in this paragraph and paragraph (*d*) referred to as the "time of disposition") that is immediately before the time that is immediately before the particular time, of each property owned by the taxpayer other than, if the taxpayer is an individual,…
>
> for proceeds equal to its fair market value at the time of disposition, which proceeds are deemed to have become receivable and to have been received by the taxpayer at the time of disposition;

[121] The Appellant's departure from Canada would have triggered the very same capital gain realized on the share sale thereby ensuring reconciliation of his capital gains and losses. To deny a tax benefit to which he was entitled by an express provision of the *Act* because he achieved it by a different legally effective means is, frankly, bizarre.

[122] "Bizarre" might be putting it too strongly, but in a manner of speaking it does underline my point that the real concern here is not so much about the use of the capital losses – it is about the acceptance or non-acceptance of surplus strips *per se*. That appears to be an issue with which the Minister struggles in a variety of circumstances.

[123] However, the circumstances of the case at bar do not invite a struggle. In this case, it just cannot be said that the purpose of the *Act*, to limit the use of capital losses to off-set capital gains, is frustrated by the surplus strip.

[124] Accordingly, having determined the object and spirit of those provisions that limit the use of capital losses is not as restrictive as asserted by the Respondent in the context of tax plans aimed at triggering capital gains; and having determined that the creation of the subject gain in this case did not frustrate the object and spirit of those provisions, I am satisfied that the avoidance transaction giving rise to the tax benefit here was not abusive. Indeed, I regard the Appellant's use of his capital losses not only did not frustrate the object and spirit of the capital loss provisions of the *Act* but rather assured him of achieving a tax benefit to which he was entitled without adverse consequences.

[125] The decision in *Canada Trustco* assures taxpayers that the principle in the *Inland Revenue Commissioners v. Duke of Westminster*[41] has not been abandoned and that the legitimate tax planning engaged in here should not be undermined by GAAR. To the contrary, the tax benefit in this case reflects nothing more than a plan undertaken not so much to minimize taxes payable, a legitimate plan in itself, but to ensure reconciliation of his capital gains and losses in Canada prior to his departure while ensuring that there were no adverse tax consequences in achieving that end. GAAR affords ministerial and judicial leeway in determining whether a transaction may reasonably be considered not to result in an abuse.[42] In spite of the myriad of principles Parliament has laid out in the *Act*, that determination must be grounded in the fair application of *those* taxing principles that must be taken as governing a particular case.

Was the Share Sale Abusive in Avoiding Dividend Treatment on the Distribution of Retained Earnings?

[126] As I said earlier in these Reasons, a driving force of the assessment was an attack on the surplus strip aspect of the impugned series of transactions.

[127] I allowed that it was implicit that the Respondent's position was that subsection 84(2) is there to prevent capital gains treatment in the case of a surplus strip or more particularly where, on a wind-up or discontinuance of a business, the retained earnings of a company have financed a share purchase. However, it is a position that does not expressly identify a tax benefit. Without that, a section 245 analysis cannot be undertaken.

[128] Insisting that the maintenance of a dividend regime *per se* is required to maintain the integrity of the scheme of the *Act* in the context of the distribution of retained earnings on a winding up or discontinuance of a business, requires that subsection 84(2) be found to operate beyond its express language. I have found to the contrary. That sits well, in my view. A proper reading of the subject provisions dictates only one approach: find the abusive benefit and look to GAAR to maintain the integrity of the scheme of the *Act* in the context of the distribution of retained earnings on a winding up or discontinuance of a business.

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[41] [1936] A.C. 1 (H.L.).

[42] *Canada Trustco*, at para. 37.

[129] While that should be the end of the matter, there is another aspect of the anti-surplus stripping position, which is at the heart of the Minister's concern with the instant appeal, that I feel compelled to address.

[130] The reality in this case is that aside from the Appellant's use of losses, the tax on capital gains in New Brunswick in 2002 differed considerably compared to the tax on dividends. Indeed, in the case of a privately-held corporation, like PC, the lack of integration, at the time the subject transactions were undertaken, favoured capital gain treatment by some nine percent in New Brunswick relative to the tax on a dividend of the same amount.[43] The question could arise then as to whether a surplus strip *per se* can be abusive just because it frustrates the operation of two very different tax regimes.

[131] That might invite a different approach as to how GAAR needs to operate or a different construction of subsection 84(2). In my view, any such change in approach would be wholly unwarranted.

[132] The tax avoidance and tax benefit resulting from a lack of integration in this case is systemic. There is no *unintended* tax slippage in this sense, and in such circumstances GAAR cannot be used to prevent a tax planned approach to accessing retained earnings. Said differently, neither subsection 84(2) nor GAAR can be used to fill a gap between two approaches to taxing an individual shareholder's realization of accumulated after-tax funds in a company. There must be more. Subsection 84(2) does not employ language that attacks tax abuse issues arising from surplus strips. Section 245 does. As stated earlier in these Reasons – it is a better litmus test to identify strips that offend the spirit and objects of the *Act* read as a whole. Unless, an abusive tax benefit results from the avoidance series of strip transactions, the tax result stands undiminished. Avoidance transactions alone do not frustrate the principles set out in the *Duke of Westminster.*

[133] Accordingly, I reiterate my finding under the previous heading, dealing more specifically with the tax benefit relied on by the Respondent in applying section 245, that the strip transactions as engaged in by the Appellant do not constitute a misuse of the provisions of the *Act* or an abuse having regard to the provisions of the *Act* read as a whole. Again, section 245 does not apply.

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[43] This occurred primarily as a result of amendments to the *Act* in 2000 that changed the capital gains inclusion rate to 50%. Previously, the dividend tax credit provisions actually allowed a tax benefit to dividends for owners of privately-held corporations.

[134] Lastly, it should be mentioned that it is implicit in these Reasons that I have not found that either employing a series of transactions with related parties on substantially arm's length terms or ensuring the availability of funds through asset liquidations to enable a payment to the Appellant to be relevant factors in the circumstances of this case in the determination that the impugned transactions were not abusive. They simply enabled a well-planned departure from Canada.

Change in Residency

[135] The Appellant concedes that if the subject PC distributions are to be re-characterized as dividends, he could be liable under Part XIII of the *Act*. He does so on the basis that his residence could be found to have changed prior to those distributions being made.

[136] I do not find it necessary to engage in an in-depth analysis of the residence issue. The Appellant did not ask me to reconsider his residency unless I found the subject distributions were to be re-characterized as dividends. I have not made that finding. As well, I accept the Appellant's filing position as to his residence in Canada until he crossed the border on June 25, 2002. It is not without merit to allow an accepted filing position which reflects a studied sequence of events aimed at ensuring that the Appellant was a resident of Canada until he crossed the US border with an immigration permit which entitled him entry as a resident there. While such a clear line cannot always be drawn, given the preparatory efforts required for a change in residence, which require both a severance of ties to Canada and the establishment of new residential ties to another country, it may not be unreasonable in cases such as this to look to the date and time of the physical departure as the date and time of a change of residence. In this case, a finding that is that precise, as to a moment in time, is possible; it reflects and coincides with the Appellant's mental, familial and personal detachment from Canada as the place he resided until he crossed the border, is possible.

[137] Further, and perhaps most importantly, there was an assumption made, as set out in the Reply, that the Appellant was a resident of Canada at the time of the distributions that are the subject of this appeal. The Appellant has not met the burden of proof imposed to him to dispel this assumption.

Conclusion

[138] Having found that subsection 84(2) does not apply to change the character of the Appellant's receipts in this case, and that the avoidance transaction in respect

of the Appellant's utilization of his net capital losses was not abusive and that the tax benefit inferentially asserted by the Respondent in respect of the surplus stripping aspect of the subject series of transactions was neither material nor abusive, I conclude that the appeal must be allowed.

[139] In closing, I add that in not applying GAAR to the share sale I am mindful of what was enunciated on more than one occasion in *Canada Trustco*; namely, that the analysis of GAAR requires consideration of fairness. Indeed in the opening paragraph of *Canada Trustco*, the Supreme Court of Canada said the GAAR framework should achieve fair results. The allowance of this appeal ensures a fair result. A tax plan that ensures the reconciliation of genuine capital losses should not be the subject of a GAAR assessment, at least in these circumstances, unless the *Act* expressly denies it.

[140] For all these Reasons, the appeal is allowed, with costs.

Signed at Ottawa, Canada this 17th day of April 2012.

"J.E. Hershfield"

Hershfield J.

SCHEDULE 1

2009-1(IT)G

TAX COURT OF CANADA

BETWEEN:

DR. ROBERT G. MACDONALD

Appellant

- and -

HER MAJESTY THE QUEEN

Respondent

AGREED STATEMENT OF FACTS

The Appellant and the Respondent, by their solicitors, admit the truth of the following facts in conjunction with any other evidence put before the Court, provided that such admissions are made for the purpose of this proceeding and any appeal there from:

1. The Appellant is a medical physician who carried on the practice of medicine as an interventional cardiologist with the New Brunswick Heart Centre at the Saint John Regional Hospital;

2. Robert G. MacDonald Professional Corporation Ltd. (the "P.C." or "050509 NB Ltd.") was incorporated under the laws of New Brunswick on September 4th, 1991;

3. The Appellant practiced at the New Brunswick Heart Centre but was employed through the P.C.;

4. From the incorporation of the P.C. until 2002, the Appellant was the sole director and shareholder, owning the issued and outstanding 100 common and 100 preferred shares;

5. James Stewart is a resident of Canada and is married to the Appellant's sister;

6. 601798 NB Ltd., was incorporated under the laws of New Brunswick on June 20, 2002, and at all times all the issued and outstanding shares were owned by James Stewart;

7. The assets of the P.C. consisted primarily of marketable securities, cash and accounts receivable;

8. In the months leading up to June 25, 2002, the Appellant caused the P.C. to liquidate its investments;

9. On June 25, 2002, the Appellant entered into an agreement with James Stewart to sell him the 100 common and 100 preferred shares of the P.C.;

10. The agreement stated that the purchase price was: 1) the book value of the accounts receivable; plus 2) the cash on hand; less 3) the liabilities; and less 4) the sum of $10,000;

11. The accountants, Teed Saunders Doyle, calculated a value based on the June 25, 2002 internal balance sheet which showed the following:

ASSETS	
Cash	$ 330,550
Accounts Receivable	70,437
Accounts Receivable—Shareholder	163,246
	$ 564,233
LIABILITIES & EQUITY	
Accounts Payable	$ 23,292
Income Taxes Payable	8,788
Capital Stock	101
Retained Earnings	532,052
	$ 564,233

12. James Stewart accepted the offer to purchase as presented;

13. The agreement called James Stewart to pay the purchase price to the Appellant by way of a non-interest bearing demand promissory note;

14. On June 25, 2002, James Stewart also acquired all the shares in the newly incorporated 601798 NB Ltd.;

15. On June 25, 2002, James Stewart transferred the shares of the P.C. to 601798 NB Ltd. in exchange for 100 common shares of 601798 NB Ltd. and a $525,068 note payable;

16. On June 25, 2002, the P.C. declared two dividends payable to 601798 NB Ltd. in the amounts of $500,000 and $10,000;

17. On June 25, 2002, the P.C. issued cheques for the amounts of $320,000 and $159,842, as partial payment of the $500,000 dividend, but neither were ever cleared through the bank account;

18. 601798 NB Ltd. then paid $479,842 to James Stewart as partial payment of the note payable to James Stewart; and James Stewart paid $479,842 to the Appellant as partial payment of the note payable to the Appellant; This was accomplished through the endorsing of cheques and the completion of adjusting journal entries;

19. On June 25, 2002, the Appellant wrote a $159,842 cheque from his personal account to the P.C. as a repayment of the amount he owed the P.C., but this cheque never cleared through his bank account;

20. On June 25, 2002, the Appellant, the P.C., James Stewart, and 601798 NB Ltd. all entered into a further agreement confirming the transactions above and providing that:

i) on September 1, 2002, the P.C. would pay a final dividend to 601798 NB Ltd., equal to its cash balances less all liabilities, which was $25,068;

ii) 601798 NB Ltd. will direct the P.C. to pay the unpaid cash dividends of $20,158 plus the $25,068 final dividend to James Stewart, as payment of the remaining balance of the note owed by 601798 NB Ltd. to James Stewart; and

iii) James Stewart in turn will direct 601798 NB Ltd. to pay the $20,158 and $25,068 to the Appellant as payment of the remaining balance of the note owed by James Stewart to the Appellant;

21. On June 26th, 2002, the P.C. filed to change its name from Robert G MacDonald Professional Corporation to 050509 NB Ltd.;

22. On July 15, 2002, 050509 NB Ltd. issued a cheque to 601798 NB Ltd. for $10,000;

23. On Aug. 27, 2002, the $10,000 cheque was deposited into a newly opened bank account of 601798 NB Ltd.;

24. Other than the $10,000 dividend all dividends were paid through journal entries and the endorsing of cheques;

25. On July 31, 2002, Articles of Dissolution were prepared for 050509 NB Ltd. and signed by the Appellant, although the company was not officially dissolved until February 4, 2005;

26. Up until the time of dissolution the Appellant was still the sole director of 050509 NB Ltd.;

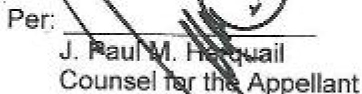
27. On his Income Tax Return for his 2002 tax year, the Appellant reported the disposition of his shares of 050509 NB Ltd. as a capital gain, as follows:

Proceed	$525,068
Less: ACB	101
Capital Gain	$524,967

~~28. James Stewart was not a medical professional and had no reason to own a professional corporation;~~

DATED at Saint John, New Brunswick, this 20th day of September 2011.

Stewart McKelvey Stirling Scales
Barristers and Solicitors
Solicitors for the Appellant



Per: ______________________
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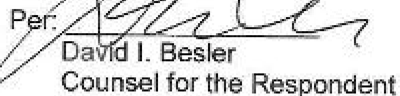
DATED at Halifax, Nova Scotia, this 20th day of September 2011.

Myles J. Kirvan
Deputy Attorney General of Canada
Solicitor for the Respondent



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TO: The Registrar, Tax Court of Canada, Ottawa, ON

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COURT FILE NO.:	2009-1(IT)G
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PLACE OF HEARING:	Fredericton, New Brunswick
DATE OF HEARING:	September 21 and 22, 2011
REASONS FOR JUDGMENT BY:	The Honourable Justice J.E. Hershfield
DATE OF JUDGMENT:	April 17, 2012

APPEARANCES:

Counsel for the Appellant:	J. Paul M. Harquail
Counsel for the Respondent:	David I. Besler

COUNSEL OF RECORD:

For the Appellant:

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