Beware - CDA Anti-Avoidance Rule

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The case of *Groupe Honco Inc. v. The Queen*, 2012 TCC 305 dealt with the question of whether capital dividends received by companies in a corporate chain pursuant to a series of transactions could be deemed not to be capital dividends by virtue of subsection 83(2.1) of the Income Tax Act (the "Act"). This subsection is a specific "anti-avoidance" provision that was introduced in 1988 to curtail "trading in CDA" – that is, acquiring shares of a company that has a capital dividend account ("CDA") balance in order to be able to pay capital dividends to the acquirer.

Although not entirely clear from the judgment, the case facts appear to be as follows:

- A corporation associated with Groupe Honco Inc. ("Honco") built a $600,000 structure for Industries Supervac Inc. ("Old Supervac").
- Old Supervac was owned and controlled by Mr. B, who subsequently was diagnosed with a terminal illness. An important fact is that Old Supervac owned a substantial life insurance policy on the life of Mr. B.
- Old Supervac ran into financial difficulties and was unable to pay for the structure. The arrangement was restructured so that Old Supervac leased rather than owned the new structure. However, this arrangement also ran into difficulties and the rental payments fell into arrears.
- Mr. L, the principal of Honco and the chain of companies involved in the tax case, entered into an arrangement with Mr. B and Old Supervac to purchase Old Supervac´s inventory and lease all its business assets, to have the trade name used by Old Surpervac transferred to a new company ("New Supervac") and to have the option to acquire all the shares of Old Supervac.
- Mr. B passed away and Old Supervac received the life insurance proceeds from the policy on his life, resulting in a CDA credit. Some of the life insurance proceeds were paid to creditors of Old Supervac, and as well $200,000 of the life insurance proceeds were used to pay a capital dividend by Old Supervac on preferred shares held by Mr. B´s widow.
- Mr. L managed the business of Old Supervac and it returned to profitability. New Supervac exercised the options to buy the business assets and shares of Old Supervac. Shortly thereafter Old Supervac and New Supervac were amalgamated into New Supervac. Pursuant to the rules in the Act, the remaining CDA balance in Old Supervac "flowed through" to New Supervac.
- After the amalgamation the CDA balance of $750,000 was paid as a capital dividend from New Supervac to Honco and then from that company to Gestion Paul Lacasse Inc. (All companies within the group were now controlled by Mr. L. The three companies are the "taxpayers" in the tax case.)

The Canada Revenue Agency reassessed the taxpayers on the basis that the capital dividends received by each of the companies were part of a series of transactions, one of the main purposes of which was to receive the capital dividend, and as a consequence subsection 83(2.1) could be applied to treat such capital dividend as a taxable dividend. The taxpayers appealed this assessment to the Tax Court.

The taxpayers argued that the rationale for the purchase of the Old Supervac shares was to be able to recover the significant investment in the construction of the structure, to continue certification to carry on the special business of Old Supervac and to acquire the losses of Old Supervac to carry forward against the future income of New Supervac. While the Tax Court agreed these were purposes of the series, it found that the availability of Old Supervac´s remaining CDA was also a main purpose of the series of transactions. The Court noted that Mr. L knew about the life insurance policy and did not say he had

“never” discussed the life insurance policy or the possible distribution of the proceeds tax-free after Mr. B´s death. He only stated that he had never heard of the CDA until after the use of Old Supervac´s losses was settled with the CRA.

The Court also noted that key advisors who may have known of the CDA and its importance in the sale did not testify. In the end, the Court was “unable to conclude that the taxpayers have discharged their burden of proof of establishing that the assessments were incorrect and that the acquisition of the capital dividend account, the value of which resided in its eligibility for distribution by way of capital dividend, was not among the principal purposes for New Supervac´s (Newco) acquiring the Old Supervac (Oldco) shares.”

This case is of interest to tax and estate planners for several reasons. It is the first case involving the application and interpretation of the CDA anti-avoidance provision. In this case perhaps the facts were against the taxpayers - terminal illness of Mr. B, the availability of life insurance proceeds, the purchase of shares of Old Supervac as well as the amalgamation and payment of capital dividends through a chain of companies in quick succession, combined with the fact that key advisors were not called to testify on behalf of the taxpayers.

However, an important and perhaps persuasive argument was not made by the taxpayers. The anti-avoidance provision in subsection 83(2.1) is qualified by an exception in subsection 83(2.3) of the Act. This provision indicates that the anti-avoidance provision “does not apply in respect of a dividend … where it is reasonable to consider the purpose of paying the dividend was to distribute an amount that was received by reason of paragraph (d) of the definition of ‘capital dividend account´ in subsection 89(1).” Paragraph (d) is the provision which allows an addition to the CDA for the receipt of life insurance proceeds by a private corporation. There is no discussion or mention of this exception from the application of the CDA anti-avoidance rule in the case. Following up with the taxpayer´s counsel it was confirmed that the taxpayer did not raise the argument at the Tax Court. However, a notice of appeal has been filed in the Federal Court of Appeal and the exception provision has now been raised as an argument by the taxpayer.

Another issue that was not discussed or examined, since the exception in subsection 83(2.3) was not argued, is whether this exception is preserved when there is a subsequent payment of a capital dividend through a chain of companies. Subsection 83(2.2) appears to have the intent to preserve the exception where a dividend is paid to an individual from another corporation which received a capital dividend arising from life insurance proceeds. The explanatory notes to the original legislation state: “New subsection 83(2.1) will not apply where a capital dividend funded by life insurance proceeds is paid to an individual either directly or through a holding corporation by reason of subsection 83(2.2)”. Despite the explanatory notes to subsection 83(2.2), there may be a technical gap in the legislation when there are two or more tiers of companies that the capital dividend flows through.

On the other hand, once a corporation in the chain qualifies under the exception for life insurance proceeds, it might be argued that this should negate the CRA´s ability to use the specific anti-avoidance rule and therefore prevent this potential technical gap from even arising. As well, the factual circumstances surrounding the acquisition of the shares of the lower tier corporation (rather than the shares of the corporation that had the “original” CDA) will have to be examined by the Courts and this may also take the situation outside the ambit of the anti-avoidance provision.

As can be seen, the tax provisions governing this area are somewhat complex and are highly fact dependent. Unfortunately, because the exception provisions were not argued in this case, we will have to see if the Federal Court of Appeal will allow arguments to be made by the taxpayer on this basis. If this is not permitted, we may have to wait for another case to determine how the exceptions interact with the specific anti-avoidance rules.

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