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Right Back Where We Started? MacDonald Case Reversed on Appeal

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Introduction

Tax advisors considering a "pipeline plan" for clients were no doubt closely following the case of *MacDonald v. R.[1]* from the time of the Tax Court´s decision in April 2012 through to the Federal Court of Appeal´s decision reversing the Tax Court in April 2013. This article will review the Federal Court of Appeal´s decision and in particular will discuss the impact of this decision with respect to post-mortem pipeline planning.

The Facts

To quickly recap, this case involved Dr. Robert MacDonald, who had carried on a medical practice in Canada and had a professional corporation (a "PC") relating to his practice. After deciding to leave Canada, his advisors developed a tax plan to dispose of the shares of his corporation prior to departure, giving rise to a capital gain, which afforded the use of capital loss carry-forwards Dr. MacDonald had available. This was preferable to a straightforward wind-up of the PC that would have resulted in a deemed dividend in Dr. MacDonald´s hands.

The plan involved the following steps:

- The corporation´s assets were liquidated and it was effectively converted into a holding corporation rather than a professional corporation.
- The taxpayer´s brother-in-law ("JS") formed a new corporation ("Acquireco").
- JS acquired the shares of PC from the taxpayer, paying for them with a promissory note. The purchase price was determined by a formula but total consideration was $525,068.
- Acquireco then acquired the shares of PC from JS in exchange for shares of Acquireco and a note in the amount of $525,068.
- PC declared two dividends, one for $500,000 and a second for $10,000. In partial payment of these, it issued two cheques, one for $320,000 and another for $159,842.
- Acquireco endorsed these cheques to JS who in turn endorsed the cheques to the taxpayer as partial payment of the note.
- The taxpayer wrote a cheque to PC for an unrelated amount owing to PC in the amount of $159,842. This cheque "offset" the PC cheque in the same amount that had been endorsed to the taxpayer, and was never cashed.
- The cheque for $320,000 held by the taxpayer was not cashed, but rather booked by PC as a payable to the taxpayer.
- PC subsequently declared a final dividend to Acquireco equal to the amount still owing on the note, namely $25,068. This amount, plus the unpaid portion of the dividend declared earlier, was booked by PC as an indebtedness to the taxpayer on the basis that PC owed the amount to JS and JS in turn owed that amount to the taxpayer pursuant to the note issued on the original sale.
- Subsequently PC paid the amount of $10,000 to Acquireco and following this PC was dissolved.

The CRA reassessed Dr. MacDonald on the basis that he was deemed to have received a taxable dividend under subsection 84(2) of the *Income Tax Act*.[2] That subsection deems a dividend to have

been received when funds or property of a corporation have been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares on a winding up, discontinuance or reorganization of the corporation´s business. The deemed dividend is equal to the amount or value of what is distributed (here, the amounts paid on the note), less the amount by which the paid-up capital in respect of the shares of that class is reduced by the distribution or appropriation. The purported distribution to a shareholder here was the payment of PC´s cash to the taxpayer in settlement of the note issued by his brother-in-law as consideration for the purchase of the PC shares. The reassessment further relied on the general anti-avoidance rule.[3]

The Tax Court Decision

The Tax Court held in favour of Dr. MacDonald, determining that subsection 84(2) did not apply and that this conclusion was not altered by the application of the general anti-avoidance rule. In short, the Tax Court concluded that subsection 84(2) should be read more narrowly than the CRA proposed, and did not apply in the circumstances as the taxpayer had received the PC funds as a creditor of PC and not as a shareholder.

The Tax Court found that the express language of "in any manner whatever" does not redirect to whom the dividend was paid or distribution or appropriation made, but rather only looks to the manner of effecting the distribution to the shareholder at the time of that distribution. In so finding, the Tax Court considered relevant jurisprudence and determined that the interpretation of the provision adopted by the Tax Court in *McNichol v. R*.[4] was persuasive. This is notable as on the subject of subsection 84(2) *McNichol* is something of an outlier – a contrary view on the scope of subsection 84(2) as to the meaning of "in any manner whatever" can be found in several other cases (discussed below). Further, while the Court endorsed the *McNichol* approach to interpreting subsection 84(2), it did not then follow the case when it considered whether GAAR would apply (it should be recalled that the Tax Court in *McNichol* went on to hold that GAAR did apply to convert the capital gain into a dividend).

In light of the previous jurisprudence and the determination on GAAR, it was not surprising that the Minister chose to appeal the case.

The Federal Court of Appeal´s Decision

The Federal Court of Appeal starts with a summary of key findings of fact made by the Tax Court. These include that the share sale was carried out "by way of a non-arms-length series of transactions designed to give [Dr. MacDonald] access to essentially all of the assets of PC" and that this series of transactions was effected during the course of the winding up of PC´s business including, during the period leading up to the transaction, that Dr. MacDonald "caused PC to liquidate its investments" and at all times Acquireco was "an inactive holding company."

Working directly from the Tax Court´s findings of fact, the Federal Court of Appeal notes that PC was a Canadian resident corporation, and that the series of transactions undertaken was intended to achieve the termination of PC, and did so. Further, at the commencement of the series of transactions, the taxpayer was the sole shareholder of PC, which had cash or near cash of approximately $500,000. Then, the Court observes, by the end of the series the money had become the property of Dr. MacDonald, except for the $10,000 retained by his brother-in-law. The Court then asks whether, because of the manner in which the money moved from PC to Dr. MacDonald, his receipt of that money falls within the scope of subsection 84(2).

The Federal Court of Appeal adopted an approach that it described as a textual, contextual and purposive analysis of the provision. This lead the Court to look to: (i) who initiated the winding-up, discontinuance or reorganization of the business; (ii) who received the funds or property of the corporation at the end of that winding-up, discontinuance or reorganization; and (iii) the circumstances in which the purported

distributions took place. The Court comments that this approach is consistent with the jurisprudence interpreting this provision.

The jurisprudence referred to by the Court includes *Merritt v. Canada (Minister of National Revenue)[5]* and *Smythe v. Canada (Minister of National Revenue),*[6] the latter a 1970 decision of the Supreme Court of Canada. Both of these cases involve the sale of the assets and business of a company to another company for consideration of cash or debt and shares of the other company that were received by the shareholders of the first company. In *Merritt* the Court held that it was immaterial that the consideration received by the appellant for her shares happened to reach her other than by a direct distribution from the company being wound up. In *Smythe*, the Supreme Court was concerned that the total consideration for the transfer of assets ought to have been received by the vendor company rather than by its shareholders. In holding that the predecessor of subsection 84(2) clearly applied, the Supreme Court looked at the circumstances of the transactions at the end of the winding-up to conclude that the transactions were artificial and that their sole purpose was "to distribute or appropriate to the shareholder the 'undistributed income on hand´ of the old company."

The Federal Court of Appeal then turned to consideration of *RMM Canadian Enterprises Inc. v. R*.,[7] a Tax Court of Canada decision of Mr. Justice Bowman in which the critical words of subsection 84(2) were interpreted as follows:

"The words, 'distributed or otherwise appropriated *in any manner whatever* on the winding-up, discontinuance or reorganization of its business´, are words of the widest import, and cover a large variety of ways in which corporate funds can end up in a shareholder´s hands."

In the Federal Court of Appeal´s view, the Tax Court of Canada in the instant case erred in focusing exclusively on the legal character of the various transactions in the series, which led it to fail to give effect to the statutory phrase "in any manner whatever," and further this was not consistent with *Merritt*, *Smythe* or *RMM*.

In sum, the Federal Court of Canada concludes:

"In this case, at the end of the winding up, all of PC´s money (net of the $10,000 compensation to the accommodating brother-in-law) ended up through circuitous means in the hands of Dr. MacDonald, the original and sole shareholder of PC who was both the driving force behind, and the beneficiary of, the transaction. In my view, the only reasonable conclusion is that subsection 84(2) applies."

Having concluded that subsection 84(2) applied to the transactions there was no need for the Court to consider the Tax Court´s views on the application of GAAR.

Where Does this Leave Pipeline Planning?

Pipeline planning shares many features of the tax plan implemented by Dr. MacDonald in the instant case and the Tax Court commented on the CRA´s administrative position on such planning. The CRA has provided favourable rulings on pipeline plans but appears to require a continuation of the operating company´s business for some period of time post-death – generally a year but this has varied – and a delayed or gradual distribution of the corporate assets to the recipient. In *MacDonald*, the Tax Court made the point that if the narrower interpretation of subsection 84(2) prevailed, then the requirements apparently imposed by the CRA to obtain a favourable ruling were unnecessary and not supported by the legislation.

An excellent review of the CRA´s administrative position is found in the article "Post-Mortem Planning: Update on Pipeline Planning" by Carol Brubacher (see *INFOexchange* 2012, Vol. 1). The author includes

commentary concerning responses to questions asked at CRA Roundtables at STEP and CTF conferences in 2011, concerning the pipeline planning requirements, and asks:

“So where does this leave us? In the view of the author, the CRA´s response at the 2011 CTF Foundation Conference helps draw a clearer line between what in the CRA´s view is acceptable pipeline planning and what will be considered surplus stripping pursuant to subsection 84(2). “Good” pipeline planning would include a continuation of the original company (and the company´s business assets (i.e., not a “cash corporation”)) for a period of at least a year following the pipeline implementation, followed by a progressive distribution of the company´s assets over an additional time period.”

In the year that elapsed between the Tax Court´s decision and the Federal Court of Appeal´s reversal, the CRA issued at least two rulings[8] that were consistent with those previously issued. In each case the CRA ruled that subsection 84(2) did not apply and that GAAR would also not apply to redetermine the tax consequences of the planning. Notably both of these ruling appear to have involved fact patterns that generally adhered to the features of “good” pipeline planning noted above. Given the *MacDonald* case was under appeal and in the CRA´s view wrongly decided, one would not have expected a change in approach. With the clear reversal of that case by the Federal Court of Appeal, however, might a further change be expected?

The Federal Court of Appeal´s decision can be viewed as restoring the law to the position it was in before the *MacDonald* case arose. As noted above, the jurisprudence that formed the backdrop to the case had held that subsection 84(2) was to be broadly read (or, more recently, that GAAR applied even if subsection 84(2) did not). In light of this, the CRA´s required “good” facts could be viewed as allowing the pipeline plan to be distinguished from the types of fact patterns covered in this jurisprudence. The requirements are arguably consistent with the purchaser acquiring and carrying on a business, even if done with a view to liquidating its assets and in anticipation that the proceeds would be used to fund the purchase price, rather than simply facilitating the distribution to the shareholders. While the Federal Court of Appeal´s decision makes it clear that the meaning of “in any manner whatever” should be broadly read, it also makes it clear that the determination will depend on the facts and context – as the Federal Court of Appeal states, a textual, contextual and purposive interpretation requires the consideration of several factors that will inform whether the provision will apply.

So, to return to the question, where does this leave us? It appears that things may be back to where they were before the Tax Court of Canada´s decision in *MacDonald* – but not any further behind.

About the Author

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Endnotes

[1] 2012 TCC 123 (Tax Court of Canada).

[2] R.S.C 1985, c.1 (5th Supplement), as amended, hereinafter referred to as the “Act”. Unless otherwise stated, statutory references in this article are to the Act.

[3] Section 245 of the Act.

[4] 97 D.T.C. 111 (Tax Court of Canada).

[5] [1941] Ex.C.R.175, rev´d on other grounds [1942] 2. D.L.R.465. This case dealt with a predecessor provision to subsection 84(2).

[6] [1970] S.C.R. 64. This case also dealt with a similarly-worded predecessor to subsection 84(2).

[7] *RMM Canadian Enterprises Inc. v. R*., 97 D.T.C. 302 (Tax Court of Canada).

[8] See 2011-0401811R3 and also 2012-0464501R3.