

Federal Court of Appeal



Cour d'appel fédérale

Date: 20121015

Docket: A-359-11

Citation: 2012 FCA 259

**CORAM: NOËL J.A.
SHARLOW J.A.
MAINVILLE J.A.**

BETWEEN:

1207192 ONTARIO LIMITED

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Ottawa, Ontario, on September 25, 2012.
Judgment delivered at Ottawa, Ontario, on October 15, 2012.

REASONS FOR JUDGMENT BY:

SHARLOW J.A.

CONCURRED IN BY:

**NOËL J.A.
MAINVILLE J.A.**



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REASONS FOR JUDGMENT

SHARLOW J.A.

[1] The appellant 1207192 Ontario Limited (Numberco) has appealed the judgment of Justice Paris of the Tax Court of Canada (2011 TCC 383). That judgment dismissed Numberco's appeal of an assessment made under the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.).

[2] This appeal was heard immediately after the appeal in *Triad Gestco Ltd. v. Her Majesty the Queen* (A-286-11, on appeal from 2011 TCC 259), a similar GAAR case. In a judgment released

today, this Court dismissed the *Triad Gestco* appeal (2012 FCA 258) on the basis of the only issue raised in that case, which was whether the taxpayer was entitled to the benefit of subsection 245(4) (the “misuse or abuse rule”) because it may not be reasonably considered that the transactions in issue would result directly or indirectly in a misuse of one or more provisions of the *Income Tax Act* or in an abuse having regard to those provisions of the *Income Tax Act*, other than section 245, read as a whole.

[3] The facts in this case differ in many respects from the facts in *Triad Gestco*, but they also have the following elements in common. The taxpayer is a corporation controlled by an individual. The taxpayer transferred property to its wholly owned subsidiary corporation in exchange for shares of like value. The taxpayer then sold the shares for less than the taxpayer’s cost and used the resulting capital loss to offset a capital gain realized in a prior arm’s length transaction. The purchaser of the shares was a trust established for the benefit of the controlling shareholder of the corporation (or his family). The sale of the shares occurred immediately after the payment of a stock dividend on a separate class of shares of the subsidiary. The effect of the stock dividend was to shift value from the shares that were to be sold to the trust to the shares of the class in which the stock dividend was paid, which the taxpayer retained.

[4] In both cases, the taxpayer was reassessed to deny the capital loss on the basis of GAAR. On appeal to the Tax Court of Canada, the reassessments were upheld by Justice Favreau in the *Triad Gestco* case, and by Justice Paris in the *Numberco* case. In this appeal, involving *Numberco*, the existence of a tax benefit (the capital loss) is conceded. There is a dispute as to the existence of an avoidance transaction and the applicability of the misuse or abuse rule.

Avoidance transaction

[5] The first issue to be determined in this case is whether the admitted tax benefit realized by Numberco, the capital loss on Numberco's sale of the Newco shares, is the result of an "avoidance transaction" as defined in paragraph 245(3) of the *Income Tax Act*. That provision reads as follows:

245. (3) 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.

245. (3) L'opération d'évitement s'entend :

a) soit de l'opération dont, sans le présent article, découlerait, directement ou indirectement, un avantage fiscal, sauf s'il est raisonnable de considérer que l'opération est principalement effectuée pour des objets véritables — l'obtention de l'avantage fiscal n'étant pas considérée comme un objet véritable;

b) soit de l'opération qui fait partie d'une série d'opérations dont, sans le présent article, découlerait, directement ou indirectement, un avantage fiscal, sauf s'il est raisonnable de considérer que l'opération est principalement effectuée pour des objets véritables — l'obtention de l'avantage fiscal n'étant pas considérée comme un objet véritable.

[6] Subsection 245(3) requires a determination of the primary purpose of the transaction or series of transactions that is alleged to comprise the avoidance transaction. That is a factual enquiry (*Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 at paragraph 29) resulting in a finding of mixed fact and law that must stand absent a palpable and overriding factual error or an extricable error of law (*Housen v. Nikolaisen*, 2002 SCC 33 at paragraphs 26 to 37). The burden is on the taxpayer to establish that a particular transaction or series of transactions was undertaken or

arranged primarily for *bona fide* purposes other than to obtain a tax benefit (*Trustco* at paragraph 66).

Facts

[7] The basic facts are undisputed and are fully stated in the reasons of Justice Paris. Only a summary is necessary here.

[8] In the fall of 2002, Mr. Cross was in the course of severing his connections with a corporation called Hub International Limited. It was necessary to have his corporation, Numberco, sell its shares of Hub International Limited to an arm's length purchaser. That was done. The sale resulted in a capital gain of approximately \$3 million.

[9] At the same time, Mr. Cross was about to embark on a new business venture entailing significant risk of personal liability. He was sensitive to that kind of risk, having gone through personal bankruptcy some years before. Mr. Cross sought advice from an accountant on obtaining protection from potential future creditors.

[10] The accountant advised Mr. Cross to follow a plan devised for another client of the accountant's firm. That other client had been given a legal opinion to the effect that the steps described in the plan would achieve the desired creditor protection. The accountant concluded that the same creditor protection would be achieved for Mr. Cross.

[11] In January of 2003, after Mr. Cross had made the decision to put the creditor protection plan into effect, the accountant discovered that the implementation of the plan exactly as set out in the other client's file, in addition to meeting the creditor protection objective sought by Mr. Cross, would also have the happy result of creating a capital loss for Numberco of approximately \$3 million that could offset the \$3 million capital gain realized by Numberco on sale of the Hub shares.

[12] The steps in the plan that would have that beneficial tax result were essentially those described in paragraph 2 above. The transactions as completed are described as follows in paragraphs 7 to 15 of the statement of agreed facts filed in the Tax Court:

7. On February 20, 2003, 2022900 Ontario Inc. ("Newco") was incorporated. Mr. Cross was the sole director of Newco at all material times.

8. The authorized capital of Newco is unlimited numbers of Class A special shares, Class B special shares and common shares, with the following attributes:

(a) the Class A special shares had no dividend entitlement but had a voting entitlement of 10 votes per share. These shares were redeemable at the amount of their stated capital. In the event of a wind-up or liquidation of the corporation, the Class A special shares ranked ahead of the common shares for payment but payment was limited to the amount of the stated capital;

(b) the Class B special shares while owned by the initial owner were entitled to non-cumulative dividends at the discretion of the directors. Otherwise their dividend entitlement was 6% of stated capital. They had paid up capital ("PUC") of \$100 and were redeemable from the initial owner for \$100 per share. Other than for the initial owner the redemption amount was the stated capital of the shares plus any unpaid dividends. They were retractable for the amount of their stated capital. In the event of wind-up or liquidation of the corporation, the Class B special shares ranked ahead of all other shares for payment but payment was limited to the amount of their stated capital. These shares were non-voting; and

(c) the common shares were entitled to dividends at the discretion of the directors, even in preference to other classes of shares. Each common share bore one vote.

9. On February 25, 2003, the Cross Family Trust was founded:

- (a) Ruth Cross (Mr. Cross' mother) was the settlor;
- (b) the object settled was a gold coin;
- (c) the Cross Family Trust was established as a discretionary trust; and
- (d) Marylee Cross (Mr. Cross' wife), Robert Lesperance (Mr. Cross' brother-in-law) and Paula Adams (Mr. Cross' lawyer) were the trustees. The trustees made decisions for the trust according to majority rule. The income and capital beneficiaries of the Cross Family Trust were Marylee Cross and the couple's children, Laura and Amy.

10. On February 25, 2003, the Cross Voting Trust was founded:

- (a) Ruth Cross was the settlor;
- (b) The object settled was a \$100 bill;
- (c) The Cross Voting Trust was established as a discretionary trust; and
- (d) Mr. Cross, David Cross (Mr. Cross' brother) and Daniel Skellett (Mr. Cross' friend) were the trustees. The appointment of the trustees had to be approved by the director of [Numberco], being Mr. Cross. The trustees made decisions for the Cross Voting Trust according to majority rule. Marylee Cross, Laura Cross and Amy Cross were both income and capital beneficiaries of the Cross Voting Trust. Mr. Cross was an income beneficiary.

11. On or about February 26, 2003, [Numberco] purchased marketable securities worth \$2,847,505. It also retained \$152,495 in cash to establish a block of assets with a total fair market value ("FMV") of \$3,000,000.

12. On February 27, 2003, [Numberco] transferred its cash and securities with a FMV of \$3,000,000 to Newco and was issued from treasury 30,000 common shares in Newco with a stated capital of \$2,999,900.

13. On February 27, 2003, Newco declared a stock dividend of 1 Class B special share per common share. [Numberco] received 30,000 Class B special shares with a redemption value, to the initial investor, of \$3,000,000 and PUC/ACB of \$100.

14. On February 27, 2003, the Cross Voting Trust subscribed for 10,000 Class A special shares in Newco and paid \$100 for these shares. This purchase gave the Cross Voting Trust 100,000 votes with respect to Newco and, thus, control of Newco.

15. On February 28, 2003, [Numberco] sold its 30,000 common shares in Newco to the Cross Family Trust for \$100.

[13] The \$3 million capital loss resulting from Numberco's sale of the Newco common shares to the Cross Family Trust was applied against the \$3 million capital gain realized by Newco on the sale of its Hub shares. Numberco was reassessed under GAAR to disallow the deduction of the capital loss. Numberco appealed the reassessment to the Tax Court of Canada.

Analysis

[14] Justice Paris accepted that the principal objective of Mr. Cross in entering into these transactions was to achieve protection from potential future creditors. It was important for that objective that the Class B special shares of Newco – the shares that Numberco ended up holding – would be valued at \$3 million as long as Numberco held them, but would be of no value to any subsequent holder because the redemption value to a subsequent holder would be limited to their low paid up capital. There is no basis upon which this Court can or should disturb the conclusion of Justice Paris that the entire series of transactions, as set out in the plan adopted by Mr. Cross, had a *bona fide* non-tax purpose (protection against potential creditors).

[15] However, Justice Paris went on to consider whether this plan had within it one or more transactions having as their principal purpose the achievement of the admitted tax benefit (the capital loss). It seems to me that in considering the purpose of a subset of the entire series of transactions, Justice Paris had in mind the correct test. As this Court said in *MacKay v. Canada*, 2008 FCA 105 at paragraph 25:

The existence of a *bona fide* non-tax purpose for a series of transactions does not exclude the possibility that the primary purpose of one or more transactions within the series is to obtain a tax benefit.

[16] The capital loss was the result of Numberco's sale of the Newco common shares (which had a cost to Numberco of \$3 million) to the Cross Family Trust for \$100 immediately after their value had been shifted to the Class B special shares by means of the stock dividend. Achievement of that tax benefit required Numberco to purchase common shares of Newco for \$3 million, devalue them by shifting their value to the Class B special shares, and then sell them at a loss. This subset of the series of transactions undertaken is an avoidance transaction if it – that is, the subset – was undertaken primarily to obtain the tax benefit (the capital loss).

[17] As Justice Paris correctly noted, there is no evidence that the creditor protection objective required the issuance of Newco common shares to Numberco. Or, to put in another way, there is no evidence that the creditor protection objective could not have been achieved by having Numberco acquire the Class B special shares directly from Newco for \$3 million. That absence of evidence, on a point on which the onus of proof rested on Numberco, led Justice Paris to find that the issuance of common shares of Newco to Numberco was not done primarily for a *bona fide* non-tax purpose.

[18] It is argued for Numberco that Justice Paris erred in reaching this conclusion because he “proceeded on a purely objective basis without due regard to the evidence” (specifically, the evidence of Mr. Cross as to his subjective motivation for the transactions).

[19] The evidence was that Mr. Cross followed the plan he was given, exactly as it was given, because he understood that each and every step in the plan was essential to achieve the desired creditor protection. Numberco's position is that from the point of view of Mr. Cross, the tax benefit was purely incidental, a benefit that was welcome but did not displace creditor protection as the

reason why he chose to put the entire plan into effect. It is argued that in the face of that evidence, the only conclusion reasonably open to Justice Paris is that the subjective motivation of Mr. Cross for undertaking every step in the planned series of transaction was to achieve creditor protection, and therefore every step must be taken to have had a *bona fide* non-tax purpose.

[20] I am unable to accept this argument. In my view, Justice Paris followed the correct approach when he determined the purpose of the series of transactions on an objective basis – that is, by ascertaining objectively the purpose of each step by reference to its consequences – rather than on the basis of the subjective motivation of Mr. Cross, or his subjective understanding of what may or may not have been required to achieve creditor protection. In the absence of any evidence that the subset of steps identified by Justice Paris were required for creditor protection, it was open to him to conclude that their principal purpose was to achieve the admitted tax benefit.

Misuse or abuse

[21] The facts of this case that are relevant to the application of the misuse or abuse rule are substantially the same as those in *Triad Gestco*. As mentioned above, this Court has today dismissed the appeal of *Triad Gestco* on that point, in large part for the reasons expressed by Justice Paris in this case. I would reach the same conclusion in this case, substantially for the reasons expressed in *Triad Gestco*. Therefore, I would adopt the conclusion of Justice Paris that the saving provision in subsection 245(4) does not apply in this case to justify a reversal of the GAAR reassessment.

Conclusion

[22] For these reasons, I would dismiss the appeal with costs.

“K. Sharlow”

J.A.

“I agree
Marc Noël J.A.”

“I agree
Robert M. Mainville J.A.”

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET: A-359-11

(APPEAL FROM A JUDGMENT OF THE HONOURABLE JUSTICE B. PARIS OF THE TAX COURT OF CANADA DATED SEPTEMBER 7, 2011, DOCKET NO. 2008-2482(IT)G)

STYLE OF CAUSE: 1207192 Ontario Ltd. v. HMQ

PLACE OF HEARING: Ottawa, Ontario

DATE OF HEARING: September 25, 2012

REASONS FOR JUDGMENT BY: Sharlow J.A.

CONCURRED IN BY: Noël J.A.
Mainville J.A.

DATED: October 15, 2012

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