Docket: 2014-4756(IT)G

BETWEEN:

626468 NEW BRUNSWICK INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeal heard on November 20, 2017, at Halifax, Nova Scotia.

Before: The Honourable Justice Johanne D'Auray

Appearances:

| | |
|---|---|
| Counsel for the Appellant: | Brian K. Awad |
| Counsel for the Respondent: | David I. Besler |

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**JUDGMENT**

The appeal from the assessment made under the *Income Tax Act* for the 2006 taxation year is dismissed with costs in favour of the respondent.

Signed at Ottawa, Canada, this 25th day of May 2018.

"Johanne D'Auray"

D'Auray J.

Citation: 2018 TCC 100
Date: 20180525
Docket: 2014-4756(IT)G

BETWEEN:

626468 NEW BRUNSWICK INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

**REASONS FOR JUDGMENT**

D'Auray J.

I. INTRODUCTION

[1] The question in this appeal is whether the computation of safe income is made *before or after* tax?

[2] I am of the opinion that taxes have to be taken into account in computing the amount of safe income, for the following reasons.

II. FACTS

[3] Mr. Rodney J. Gillis is a lawyer. In mid-2006, he personally owned an apartment building located at 411 Ellerdale Street in Saint John, New Brunswick ("the Ellerdale property" or "property").

[4] An unrelated party was interested in buying the Ellerdale property.

[5] Mr. Gillis was aware that the selling of the property would result in a capital gain. He therefore retained the accounting firm BDO Dunwoody LLP ("BDO") to advise him as to how to structure the sale of the Ellerdale property in a tax efficient manner.

[6] Mr. Ralph Neville, a chartered accountant at BDO, prepared a memorandum setting out a tax structure in order to minimize the taxation consequences that would result from the sale of the Ellerdale property.

[7] Mr. Gillis agreed to implement the tax structure proposed by Mr. Neville. Accordingly, the following steps were undertaken:[1]

(a) Tri-Holdings Ltd. ("Tri-Holdings") was incorporated under the laws of New Brunswick. Mr. Gillis was the only shareholder.

(b) In November 2006, Mr. Gillis transferred the Ellerdale property to Tri-Holdings as a capital property.

(c) The consideration provided by Tri-Holdings for the Ellerdale property to Mr. Gillis was (1) an agreement to assume a portion of the mortgage on the Ellerdale property equal to the book value of the property, and (2) 100% ownership of Tri-Holdings, comprising four common shares.

(d) The shares of Tri-Holdings were assigned a nominal paid-up capital ("PUC") amount of $4.00.

(e) Mr. Gillis filed a form T2057 to advise the Canada Revenue Agency ("CRA") that a rollover pursuant to subsection 85(1) of the *Income Tax Act* (the "*Act*") had been effected at the book value of the Ellerdale property ("the first rollover").

(f) On November 30, 2006, Mr. Gillis transferred his four shares in Tri-Holdings to the appellant, 626468 New Brunswick Inc. ("468"), a New Brunswick company, in exchange for 100% ownership, comprising four common shares ("the second rollover"). Mr. Gillis and 468 filed a form T2057 to advise CRA that the second rollover had been effected at the PUC amount for the Tri-Holdings shares−$4.00.

(g) Subsequently, Tri-Holdings sold the Ellerdale property to an unrelated party. As a result, Tri-Holdings realized a capital gain and a recapture of capital cost allowance.

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[1] The tax planning structure was part of the Partial Agreed Statement of Facts filed by the parties at trial.

(h) Fifty percent of the capital gain, namely $1,319,500, was accounted for in Tri-Holdings' capital dividend account ("CDA"). The other fifty percent of the capital gain, along with the recaptured depreciation, totalled $3,079,184.

[8] After the sale of the Ellerdale property, Tri-Holdings proceeded to increase the PUC of its common shares as follows:

| | |
|---|---|
| December 13, 2006 | $1,500,000. |
| December 14, 2006 | $200,000. |
| December 15, 2006 | $100,000. |
| December 16, 2006 | $50,000. |
| December 17, 2006 | $29,120. |
| December 18, 2006 | $569,093. |
| Subtotal | $2,448,213. |
| December 15, 2006 | $1,319,500. (capital dividend) |
| Total | $3,767,713. |

[9] Tri-Holdings increased of its PUC in stages, resulted in deemed taxable dividends to 468, pursuant to subsection 84(1) of the *Act*. The deemed dividends had the effect of increasing 468 adjusted cost base in its shares of Tri-Holdings pursuant to paragraph 53(1)(b) of the *Act*, resulting in no capital gain when 468 sold its shares in Tri-Holdings.

[10] There were no tax consequences for 468 with respect to the generated deemed dividends since, pursuant to section 112 of the *Act*, 468 was entitled to deduct the amount of the deemed dividends as they were intercorporate dividends.

[11] With respect to the capital dividend in the amount of $1,319,500 which was the balance of Tri-Holding's CDA, there was no tax consequence to 468 pursuant to subsection 83(2) of the *Act*.

[12] On December 29, 2006, 468 sold all its shares in Tri-Holdings for $3,767,616 to Wilshire Technology Corporation.

[13] After subtracting a capital loss on the sale of its Tri-Holdings shares, 468 had a net income of $3,767,707 for its 2006 taxation year.

[14] For its 2006 taxation year, 468 reported a nil taxable income:

| | |
|---|---|
| Net income | $3,706,856 |
| T2 for 2006 | |
| Net income per financial statements | $3,706,856 |
| Non-taxable dividends | $1,319,500 |
| Net income for income tax purposes | $2,447,907 |
| Taxable dividends (deductible under s. 112(1)) | $2,448,212 |
| Taxable income | $ Nil |

[15] On December 31, 2006, Tri-Holdings was continued as a British Columbia corporation under the name 077825 BC Limited ("825"), and it entered into an agreement to acquire software from Securitas Video Corporation; Tri-Holdings/825 deducted a capital cost allowance ("CCA") based on the cost of the software acquired. The Minister of National Revenue (the "Minister") denied Tri-Holdings/825's CCA claim. At the time of the trial, this assessment was under objection.

[16] The Minister reassessed 468 on the basis that the deemed dividends paid to 468 exceeded Tri-Holdings' safe income, giving rise to a taxable capital gain under subsection 55(2) of the *Act*. Consequently, the Minister assessed federal income tax in the amount of $69,596, provincial income tax in the amount of $25,282 and a penalty of $16,129.26 under section 162(1) of the *Act*, and arrears interest in the amount of $52,956.35.

[17] In reassessing, the Minister assumed that Tri-Holdings had as at December 13, 2006, a taxable income of $3,079,184 and a tax liability of $1,081,586. Accordingly, the Minister took the position that the safe income of Tri-Holdings was not more than $1,998,098 and not $3,079,184 as argued by the appellant, since the safe income had to be reduced by the income tax, a calculation that had to be done at the time that was immediately before the earliest time that a

dividend was paid or deemed as part of the transaction, event or series; in this appeal before December 13, 2006.

## III. POSITION OF THE PARTIES

### A. Appellant

[18] The appellant's position is that I should give the plain meaning to the words "income earned or realized" found in subsection 55(2) of the *Act*. It argues that "income earned or realized" in subsection 55(2) of the *Act* refers to gross income or pre-tax income.

[19] The appellant argues that the language of paragraph 55(2)(c) of the *Act* is clear. Under this paragraph, the only amounts that reduce safe income are the amounts deducted under section 37.1−additional deduction for research and development−or paragraph 20(1)(gg)−inventory allowance. If the legislator wanted safe income to be reduced by income tax, it would be clearly indicated in subsection 55(2). The appellant gave examples in the *Act* where the legislator clearly referred to after-tax income by using specific terms such as "tax-paid undistributed income" and "tax-paid surplus on hand".

[20] In addition, the appellant argues that taxes become payable only at the end of the taxation year, namely in this appeal on December 31, 2006. Therefore, since at the end of its 2006 taxation year Tri-Holdings had no tax to pay, the safe income should not have been reduced.

### B. Respondent

[21] The respondent relies on the decision of Justice Bell in *Deuce Holdings*.[2] She argues that "income earned or realized" in section 55 of the *Act* refers to after-tax income. Therefore, the safe income had to be reduced by the tax liability of Tri-Holdings, a calculation that had to be made before the first deemed dividend was generated.

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[2] *Deuce Holdings Ltd. v The Queen*, 1997 CarswellNat 1240 (TCC).

[22] The respondent also argues, relying on *The Queen v VIH Logging Ltd.*,[3] that the calculation of safe income had to be made before December 13, 2006, that is immediately before the first deemed dividend was generated.

## IV. ANALYSIS

[23] The relevant portions of the provisions of the *Act* applicable in this appeal are as follows:

> 55 (2) Where a corporation resident in Canada has received a taxable dividend in respect of which it is entitled to a deduction under subsection 112(1) or 112(2) or 138(6) as part of a transaction or event or a series of transactions or events, one of the purposes of which (or, in the case of a dividend under subsection 84(3), one of the results of which) was to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition at fair market value of any share of capital stock immediately before the dividend and that could reasonably be considered to be attributable to anything other than income earned or realized by any corporation after 1971 and before the safe-income determination time for the transaction, event or series, notwithstanding any other section of this Act, the amount of the dividend (other than the portion of it, if any, subject to tax under Part IV that is not refunded as a consequence of the payment of a dividend to a corporation where the payment is part of the series)
>
> (a) shall be deemed not to be a dividend received by the corporation;
>
> (b) where a corporation has disposed of the share, shall be deemed to be proceeds of disposition of the share except to the extent that it is otherwise included in computing such proceeds; and
>
> (c) where a corporation has not disposed of the share, shall be deemed to be a gain of the corporation for the year in which the dividend was received from the disposition of a capital property.
>
> 55(5) For the purposes of this section,
>
> **(**c**)** the income earned or realized by a corporation for a period throughout which it was a private corporation is deemed to be its income for the period otherwise determined on the assumption that no amounts were deductible by the corporation under section 37.1 of this Act, as that section applies for taxation years that ended before 1995, or paragraph 20(1)(gg) of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952;

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[3] *The Queen v VIH Logging Ltd.*, 2005 FCA 36.

[24] Subsection 55(2) of the *Act* does not have as a purpose to tax intercorporate dividends. It is also not the object of subsection 55(2) of the *Act* to impose capital gains tax on all dividends paid on shares in contemplation of their sale. Subsection 55(2) will apply only where the income earned or realized is not sufficient to cover the deemed dividends or the dividends declared.

[25] As was stated by Justice Favreau in *101139810 Saskatchewan Ltd. v The Queen*[4] at paragraphs 11 and 13 of his reasons, subsection 55(2) is an anti-avoidance section that will apply in circumstances prescribed by that section. Income that has already been taxed is part of safe income and because it has already been taxed, such income may be distributed by way of dividend to other Canadian corporations without tax consequences:

> [11] Subsection 55(2) of the Act is an anti-avoidance provision that was introduced in the 1979 federal budget. It was directed against arrangements designed to use the intercorporate dividend exemption to unduly reduce a capital gain on a sale of shares. It treats the dividends in these situations either as proceeds from the sale of shares or as capital gains and not as dividends received by the corporation.
>
> [13] Generally, there are three exceptions to subsection 55(2). The first exception is included in the charging provision and covers situations where the dividend can reasonably be attributable to anything other than income earned or realized by any corporation after 1971 (commonly referred to as the "safe income" dividend). Safe income is protected from the application of subsection 55(2) because this income has been subject to corporate income tax and should therefore be allowed to be paid as a tax-free dividend to other Canadian corporations (Explanatory Notes relating to Income Tax, published on December 1997, by the Minister of Finance, p. 184).

[26] Subsection 55(2) of the *Act* will apply to a dividend if the following requirements are met:

> (1) the corporation that received the dividend was a corporation in Canada;
>
> (2) the recipient corporation was entitled to a deduction under section 112 of the *Act*;
>
> (3) the dividend was received as part of a series of transactions that resulted in a disposition of property to a person who did not deal at arm's length with the recipient of the dividend;

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4 *101139810 Saskatchewan Ltd. v The Queen*, 2017 TCC 3.

(4) a fair market value of the share immediately before the dividend would have resulted in a capital gain.

[27] The appellant conceded that the requirements of subsection 55(2) were met. Therefore, in this appeal, the only question that I have to decide is whether the tax liability should be taken into account in the calculation of the safe income.[5]

[28] This question was decided by Justice Bell in *Deuce Holdings Ltd.*[6] Justice Bell stated at paragraphs 28 to 32 of his reasons that in calculating the amount of safe income, taxes had to be extracted. Justice Bell stated as follows:

> 28. . . . The second issue is whether the computation of "safe income" is made *before* or *after* tax. The question is what is meant by the words
>
> > ... income earned or realized ... after 1971 and before ... the commencement of the series of transactions...
>
> which it is agreed commenced on March 30, 1988. These words could have been defined or described so that the consideration of this issue would have removed unnecessary uncertainty from that portion of the nearly 300 words constituting this subsection. The description in paragraph 55(5)(*c*), namely,
>
> > ... the income earned or realized by a corporation for a period throughout which it was a private corporation shall be deemed to be its income for the period otherwise determined on the assumption that no amounts were deductible by the corporation by virtue of paragraph 20(1)(gg) or section 37.1;
>
> not only does not assist in determination of whether the computation of "safe income" is made *before* or *after* tax but, by omitting any reference to tax, indeed suggests that tax should not be deducted.
>
> 29. Appellant's counsel presented submissions as to why the computation should be made before tax. He argued that "very simply, income is profit". He referred to subsection 9(1) which states,
>
> > Subject to this Part a taxpayer's income for a taxation year from a business or a property is the taxpayer's profit from that business or property for the year.
>
> He referred to *First Pioneer Petroleums Ltd. v. Minister of National Revenue* (1974), 74 D.T.C. 6109 (Fed. T.D.) and reference therein to *Attorney*

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5 See: Appellant's admission, Transcript of the hearing at pp. 49 and 50.

6 *Deuce Holdings Ltd.*, *supra*, at paragraphs 28 to 32.

*General v. Ashton Gas Co.* (1905), [1906] A.C. 10 (U.K. H.L.) at 12 where the Lord Chancellor, the Earl of Halsbury, observed

> Profit is a plain English word: that is what is charged with income tax.... The income tax is a charge upon the profits: the thing which is taxed is the profit that is made and you must ascertain what is the profit that is made before you deduct the tax - you have no right to deduct income tax before you ascertain what the profit is.

Counsel then pointed out that paragraph 18(1)(*a*) of the *Act* forbids the deduction of amounts in computing income that were not laid out for the purpose of gaining or producing income and posed the question.

> How can you then deduct the tax if you are trying to compute income?

He also pointed out that paragraph 55(5)(c) could have included the words,

> ...otherwise determined after the deduction of corporation tax and tax otherwise payable under this Act.

30. Unhappily, it seems that one must journey beyond the words in section 55 in order to determine whether the computation should be made *after* tax. That is unfortunate when the legislation could have made it clear. It is logical that subsection 55(2) take into account the fact that proceeds that would, but for a dividend, have been realized on a disposition at fair market value of any share immediately before that dividend, would have been computed *after* tax. The fair market value of a share, so far as the income element is concerned, would be valued on an *after* tax basis. No purchaser would rationally pay a price for a share of the capital stock of a corporation without taking into account tax paid or payable on that corporation's income.

31. It may be simplistic to suggest that the words

> ...other than income earned or realized ... after 1971 and before ... the series of transactions

obviously mean *after* tax income, that being the only income earned in that period that would be available for distribution by way of dividend. Such suggestion would fail to take into account

> a) the cogent argument of Appellant's counsel which gave the words under review their plain meaning,
>
> b) the fact that the *Income Tax Act* has, in the past, been specific in using terms such as “tax-paid undistributed income” and “tax-paid surplus on hand”, and

> c) appraisal surplus, from which a dividend can be paid, may be said to be attributable to income "earned or realized".
>
> 32. Before tax profit is not wholly distributable. Although it is dangerous to speculate on what the legislation was intended to mean, I conclude that in this case it is only the portion of the "income earned or realized" by the dividend paying corporation remaining *after* tax that should be included in computing "safe income".

[29] Justice Noël of the Federal Court of Appeal in *The Queen v Kruco Inc.*[7] referred to Justice Bell's decision in *Deuce Holdings*. He agreed that the words "*earned or realized*" in subsection 55(2) refer to income after taxes. At paragraphs 38 and 39, Justice Noël states the following:

> [38] There can be no doubt that this exercise calls for an inquiry as to whether "the income earned or realized" was kept on hand or remained disposable to fund the payment of the dividend. It follows, for instance, that taxes or dividends paid out of this income must be extracted from safe income (see *Deuce Holdings Ltd.*, *supra* and *Gestion Jean-Paul Champagne Inc.*, *supra*).
>
> [39] The appellant argues that the phantom income in issue must be removed from "income earned or realized" on the same logic as dividends or taxes. Simply put, as this income does not correspond to any cash inflow, it is not (and can never have been) disposable or on hand. Hence, the appellant submits that it should also be removed from "income earned or realized".
>
> [Emphasis added.]

[30] The appellant argues that taxes have to be calculated at the end of the year and that at the end of the year Tri-Holdings did not owe any income tax. Therefore, the safe income should not have been reduced by the Minister as no taxes were payable by Tri-Holdings.

[31] I do not agree with the appellant. As stated by Justice Sharlow in *VIH Logging Ltd.*, *supra*, the phrase "income for the year" is not used in subsection 55(2) of the *Act*.

[32] Safe income has to be determined as prescribed by the *Act*. The safe-income determination time is set out in the *Act* as follows:

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[7] *The Queen v Kruco Inc.*, 2003 FCA 284.

> *safe-income determination time* for a transaction or event or a series of transactions or events means the time that is the earlier of
>
> > (a) the time that is immediately after the earliest disposition or increase in interest described in any of subparagraphs 55(3)(a)(i) to 55(3)(a)(v) that resulted from the transaction, event or series, and
> >
> > (b) the time that is immediately before the earliest time that a dividend is paid as part of the transaction, event or series;

[33] In this appeal, the safe income of Tri-Holdings had to be determined immediately before December 13, 2006, namely before the first deemed dividend was generated. This is what the Minister did, and in so doing, the Minister properly calculated the safe income by taking into account the income tax liability of Tri-Holdings.

[34] The appeal is therefore dismissed with costs in favour of the respondent.

Signed at Ottawa, Canada, this 25th day of May 2018.

"Johanne D'Auray"

D'Auray J.

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| CITATION: | 2018 TCC 100 |
| COURT FILE NO.: | 2014-4756(IT)G |
| STYLE OF CAUSE: | 626468 NEW BRUNSWICK INC. v HER MAJESTY THE QUEEN |
| PLACE OF HEARING: | Halifax, Nova Scotia |
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| REASONS FOR JUDGMENT BY: | The Honourable Justice Johanne D'Auray |
| DATE OF JUDGMENT: | May 25, 2018 |

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