The story of the cow, the pipeline and MacDonald (regarding the taxpayer's victory involving subsection 84(2) and the GAAR)

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Well, it has been quite a week… first we have a story about a runaway cow that walks up to the drive-through window at a McDonalds restaurant in Brush, Colorado. That's pretty funny stuff, but the story of the very recently released Tax Court of Canada's decision in *MacDonald*, as discussed below, is even better.

To begin, a little background. Post-mortem planning to avoid long-term double taxation for shareholders of private corporations is a fundamental planning objective. We have written about this in a paper published by the Canadian Tax Foundation and it is on our website. For Canadian tax and estate planners, one of the most common post-mortem strategies used to avoid double tax for shareholders of private Canadian corporations is the so-called "pipeline" transaction. This strategy is best illustrated by way of an example:

Example Facts

1. Mr. Apple is a Canadian resident individual.
2. Mr. Apple owns shares of "AppleCo" which is a Canadian-controlled private corporation.
3. The fair market value ("FMV") of the issued shares of AppleCo is $1M. The adjusted cost base ("ACB") of the issued shares of AppleCo held by Mr. Apple is nominal, say $1.
4. Mr. Apple dies on June 1, 2012.
5. Mr. Apple's heirs are his surviving children who are residents of Canada.

Analysis

Immediately prior to his death, Mr. Apple will be deemed to have disposed[1] of his AppleCo shares at FMV. This results in a terminal capital gain of $999,999 (FMV of $1M less ACB of $1).

Mr. Apple's heirs will inherit the shares of AppleCo with the ACB equal to $1M in the aggregate. However, how do the heirs of Mr. Apple's Estate utilize the high ACB of the AppleCo shares? One method would be for them to ultimately sell their shares of AppleCo to someone for $1M and realize no gain. However, in many cases a sale of the shares is simply not possible. Accordingly, to the extent that assets of AppleCo were paid to the shareholders, would such an extraction be able to be withdrawn up to $1M tax free? The short answer is no. The extraction of the assets from AppleCo would likely be considered a dividend or a shareholder appropriation and the high ACB in the shares held by the heirs of AppleCo would not reduce the taxable amount. This is where double tax can arise to the extent that post-mortem planning is not done.

There are two main strategies that are utilized to reduce the ultimate double tax exposure for shareholders of private corporations that may be realized upon death. The first strategy, which is not the subject of this blog, is the so called subsection 164(6) loss carryback. Very generally, the plan involves

the creation of a loss by transferring the high ACB shares held by the Estate of the deceased[2] back to the corporation for FMV consideration paid to the Estate and utilizing the resulting loss to carryback to the terminal return of the deceased. Such a transaction needs to be done on a timely basis (normally within the first taxation year from the date of the death of the deceased).

The second strategy, the "pipeline" transaction, achieves a very similar result but instead of triggering a loss that is carried back to the terminal return of Mr. Apple, the ACB of the AppleCo shares that are held by the Estate are instead transferred to a new corporation so that ultimately assets (surplus) can be removed from AppleCo. A typical "pipeline" transaction will look like the following:

1. The high ACB shares of AppleCo that are held by the Estate are transferred to a new corporation – "Newco" – (owned by the Estate) for consideration of a promissory note in the amount of $1M.
2. AppleCo will repurchase its shares that are held by Newco. This will result in a deemed dividend that will be received by Newco without tax consequences in most cases.
3. Newco will then repay the promissory note to the Estate.

The above is an oversimplified version of a "pipeline" transaction. A thorough review of the technical provisions of the Act needs to be completed before implementing a "pipeline" transaction to ensure that the plan will achieve the ultimate objective…to avoid double tax.[3]

One of the anti-avoidance rules that has lately caught the attention of the CRA regarding "pipeline" transactions has been subsection 84(2) of the Act. Subsection 84(2) reads as follows:

84(2) Distribution on winding-up, etc. — Where funds or property of a corporationresident in Canadahave 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 corporationshall be deemed to have paid at that time a dividend on the shares of that class equal to the amount, if any, by which,

(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. [emphasis added]

It appears that the CRA's previous administrative position[4] was that subsection 84(2) would not apply to "pipeline" strategies.[5]

However, in recent rulings, the CRA has stated that subsection 84(2) may apply since the corporation is effectively paying a dividend to the Estate on the winding-up of its business.[6] It appears that the distinguishing feature between the previous and recent rulings was that in the positive rulings (that subsection 84(2) would not apply) the corporation would remain a separate entity for one year and continue to carry on business during that period. The CRA has continued to make its views known that subsection 84(2) could apply in a vanilla "pipeline" transaction.[7]

However, the administrative views of the CRA have been hotly debated and in many cases roundly criticised. There have been many writings that express contrary views to the CRA's.

The Tax Court of Canada, in a case released on April 17, 2012 – *Dr. Robert G. MacDonald v. Her Majesty the Queen*[8] involved a surplus stripping transaction very similar to a vanilla "pipeline" strategy. The CRA argued that subsection 84(2) would apply to a "pipeline" transaction that had been undertaken by *Dr. MacDonald*. In a very well reasoned decision, the Tax Court found that subsection 84(2) did not apply to a "pipeline" transaction.[9] Included in the case were some very good comments that tax and estate planners should take note of when looking at post-mortem estate planning. In particular, the following paragraphs of the decision are noteworthy:

> [*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.*
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> *[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.*
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> *[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.*
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> *[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). 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 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.*
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> *[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.*
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> *[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.

[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.

Given the above, it appears that the Tax Court resurrected new life into post-mortem "pipeline" planning and reduced the uncertainty that has recently existed. It very clearly states that subsection 84(2) should not apply to vanilla post-mortem pipeline transactions.

Great news… stay tuned!

1. Pursuant to subsection 70(5) of the *Income Tax Act* (the "Act").

2. The usual result of a subsection 164(6) loss carrryback is that the Estate will end up paying tax on a "deemed dividend" for the assets received by the Estate of AppleCo whereas the previously realized and reported terminal capital gain is extinguished thus resulting in only one

level of tax as a result of the death of Mr. Apple and the ultimate extraction of AppleCo's assets to the heirs of Mr. Apple.

3. The ultimate result of the "pipeline" transaction is that assets are removed from AppleCo without the incidence of paying tax on a dividend and the terminal gain realized on the death of Mr. Apple remains…thus one level of tax.

4. See CRA Views Doc 2002-0154223 and 2005-0142111R3.

5. To the extent that subsection 84(2) applies, the Estate would pay tax on a dividend.

6. See CRA Views Doc 2009-0326961C6 and 2010-0389551R3.

7. The most recent of which was at the 2011 Canadian Tax Foundation National Conference.

8. 2012 TCC 123.

9. The Tax Court also found that the general anti-avoidance rule (the "GAAR") did not apply.