

The Federal Court of Appeal decision in MacDonald : The best things in life are worth waiting for

Kim G C Moody FCPA, FCA, TEP
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On April 26, 2012, our firm wrote about the Tax Court of Canada's decision in *MacDonald* that dealt with pipeline transactions and the possible application of subsection 84(2) of the *Income Tax Act* (the "Act"). Almost a year to the day later, April 25, 2013, the Federal Court of Appeal ("FCA") released its [decision](#) in the Government of Canada's appeal. For the reasons discussed below, the decision is an unfortunate reversal of the good news that was discussed in our previous blog.

Pipelines are typically used in a post-mortem context to avoid double tax exposure. Our previous [blog](#) discussed a typical pipeline transaction and therefore will not be replicated here. The tax risk with such transactions is whether or not subsection 84(2) of the Act will apply. Should it apply, a dividend will be deemed to have been received by the affected person. Subsection 84(2) reads as follows:

84(2) Distribution on winding-up, etc. — *Where funds or property of a corporation resident in Canada have 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 corporation shall 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 was that subsection 84(2) would not apply to "pipeline" strategies. 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. 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. However, the administrative views of the CRA have been hotly debated and in many cases roundly criticized. There have been many writings that express contrary views that of the CRA's.

The Tax Court of Canada in *MacDonald* 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 well-reasoned decision, the Tax Court found that subsection 84(2) did not apply to a “pipeline” transaction. In the recently released FCA decision, the court disagreed with the Tax Court and ultimately found that subsection 84(2) applied to the pipeline transaction at hand. Here are some of the more relevant paragraphs of the decision of the FCA:

[17] A plain reading of the text reveals several elements that are necessary for its application: (1) a Canadian resident corporation that is (2) winding-up, discontinuing or reorganizing; (3) a distribution or appropriation of the corporation’s funds or property in any manner whatever; (4) to or for the benefit of its shareholders.

[20] The Crown argues that, in determining whether subsection 84(2) applies, the focus should be on the words “in any manner whatever”. The money that was originally the property of PC, in fact, ended up in the hands of Dr. MacDonald by means of the series of transactions described above, which were designed to achieve that very result.

[21] In my view, a textual, contextual and purposive analysis of subsection 84(2) leads 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. This approach is consistent with the jurisprudence interpreting this provision and provides the consistency of approach with respect to subsection 84(2) spoken to by both parties to this appeal.

[28] The winding-up of the business of a corporation is a process. The judge here recognized in his decision that “on the winding up” as used in subsection 84(2) refers to a course of events that are part of the winding-up process” (reasons, at paragraph 84). He further specifically determined that “the sale of the shares here does not exist in a vacuum: each transaction, from beginning to end, was entered into and completed in contemplation of each other” (reasons at paragraph 109). And yet, he concluded that subsection 84(2) did not apply. In my respectful view, the judge erred in focusing exclusively on the legal character of the various transactions in the series, which led him to fail to give effect to the statutory phrase “in any manner whatever”. His interpretation is not consistent with Merritt, Smyth, or RMM.

*[29] 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 transactions. **In my view, the only reasonable conclusion is that subsection 84(2) applies, as the Crown contends.** [emphasis added]*

Ultimately, this case will be hotly debated for years. In the immediate future, we will wait to see if the taxpayer seeks leave for the Supreme Court of Canada to hear an appeal. In the short term, here are our firm’s initial thoughts:

1. Are pipeline transactions dead? We think not. However, careful consideration about the possible application of subsection 84(2) will need to be done.
2. Will the cash need to be held for a period of time before being distributed from the recipient corporation so as to ensure that the distribution does not occur “on the winding up”? It seems

like that may have to be the case. How long will that period need to be? One year or more like the CRA seems to say?

3. The FCA seemed to take a very broad approach to subsection 84(2) because of the provision's use of the phrase "...*in any manner whatever*...". This seems debatable to us. There are more specific provisions in the Act that appear to target pipelines such as section 84.1. We question why general provisions such as subsection 84(2) should have application when specific provisions like section 84.1 do not apply.
4. Can the risk of the application of subsection 84(2) be reduced by utilizing high paid up capital shares as consideration instead of promissory notes?
5. Will an amalgamation of corporations (instead of a winding up) avoid the application of subsection 84(2)? Again, something to consider.
6. No doubt the CRA will be happy with the FCA decision and use it to suggest that its recent comments regarding pipeline transactions have been correct.

Overall, we are disappointed with the decision of the FCA. Notwithstanding, this decision (pending a possible appeal to the Supreme Court) will need to be considered when implementing pipeline transactions. Accordingly, a pipeline transaction with an immediate distribution of the funds is likely to attract the application of subsection 84(2) given the reasoning in the FCA decision of *MacDonald*. However, as the old saying goes "...*the best things in life are worth waiting for*...". As #2 above indicates, it is likely that a waiting period for the distribution of funds will need to exist. Be patient!