Triple Canadian taxation possible with subsection 55(2)

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The recent Tax Court of Canada's decision in *101139810 Saskatchewan Ltd. v Queen* (2017 TCC 3) did not cover any new ground with respect to subsection 55(2), but it was a useful reminder of the pitfalls one could encounter for running afoul of that provision. This short blog highlights what went wrong, and the court's indifference to the taxpayer's predicament.

I have written a more detailed analysis of the Tax Court of Canada's decision in a *Tax for the Owner-Manager* newsletter (first published by the Canadian Tax Foundation in 2017 Vol. 17, no. 2), so I won't repeat the detailed facts of the case. What happened was a business owner indirectly held his shares in an operating company (Opco) through a holding corporation (Old Holdco). The business owner wished to sell his indirect interest in Opco to two other shareholders unrelated to him. However, in order to access his remaining lifetime capital gains deduction, the business owner had to personally incur the capital gain and, presumably, the two purchasers were unwilling to purchase Old Holdco from him. Therefore, the business owner undertook a series of transactions akin to a related party butterfly where Opco shares were spun out to two new holding corporations (New Holdcos), and he sold the two New Holdcos' shares respectively to the two purchasers. Accordingly, the business owner personally reported $2.6 million of capital gain on the sale and claimed a $0.2 million capital gains deduction.

As part of the related party butterfly transaction, Old Holdco and New Holdcos cross-redeemed shares resulting in subsection 84(3) deemed dividends of $2.6 million in aggregate to each other. In assessing whether subsection 55(2) applies, subsection 84(3) deemed dividends are subject to the "results" test: subsection 55(2) could apply if one of the results of the deemed dividend is to effect a significant reduction of the hypothetical capital gain of any share. Generally speaking, a significant capital gain reduction always occurs when a share with an adjusted cost base (ACB) and paid-up capital (PUC) significantly below fair market value (FMV) is redeemed,[1] and this was indeed what happened on the cross-share redemptions between Old Holdco and the New Holdcos. It is irrelevant that the capital gain actually occurred in the hands of the business owner, which is a different taxpayer.

Although the deemed dividends were caught by the results test, subsection 55(2) could still be avoided if one of the common exceptions to subsection 55(2) was met:

- The amount of the dividend does not exceed safe income on hand;
- There were no dispositions to or increase in interest of any of the corporations by an unrelated party so that the related party exception in paragraph 55(3)(a) applies; or
- A pro-rata distribution is made pursuant to paragraph 55(3)(b) – i.e. an unrelated party butterfly.

The problem here, of course, was that the sale of the New Holdcos to the unrelated purchasers was part of a series of transactions or events that included the cross-share redemptions. As such, the related party exception in paragraph 55(3)(a) cannot be relied on, and the transactions were also not implemented in accordance with paragraph 55(3)(b). There was also not sufficient safe income on hand to cover the entire amount of the deemed dividends.

Therefore, the result could be that the same economic gain is taxed as capital gains three times:

- The $2.6 million deemed dividend received by Old Holdco could be recharacterized by subsection 55(2) as proceeds of disposition;
- The $2.6 million deemed dividend received by the New Holdcos could be recharacterized by subsection 55(2) as proceeds of disposition; and
- The business owner is still subject to the realized $2.6 million capital gain on the sale of New Holdcos to the purchasers.

Interestingly, the Canada Revenue Agency (CRA) backed away from applying subsection 55(2) to Old Holdco and only reassessed the New Holdcos. There is no explanation of why the CRA gave this concession, but possibly, it may be that triple taxation is so unsavory that it was worried that the court may side with the taxpayer despite the clear wording of subsection 55(2).

Not surprisingly, the Court agreed that subsection 55(2) did apply. The Court also made a note of pointing out that the taxpayer "walked right into" subsection 55(2) as Parliament intended, and that it was incumbent on the taxpayer to structure its affairs properly to avoid subsection 55(2). It also stated that the result is not legally considered as "double taxation," because the gains arose in the hands of different taxpayers (regardless of the fact that they are of the same underlying economic gain).

What is the moral of the story here? The taxpayer walked into subsection 55(2) because it attempted to restructure a share sale using certain "canned" mechanics without fully appreciating associated nuances. The business owner might have achieved his objective of claiming capital gain deductions without causing subsection 55(2) to apply if the sale was properly structured. We as tax planners need to be 'eyes wide open' every time we come across a significant inter-corporate dividend – deemed or actual – as there is no re-do (see the recent Supreme Court of Canada decision on the remedy of rectification in *Canada v Fairmont*) and no sympathy from the Courts if we trip into subsection 55(2).

[1] This is because the definition of proceeds of disposition in section 54 of the *Canadian Income Tax Act* excludes a subsection 84(3) deemed dividend. Therefore, if a share with low ACB and PUC is redeemed, the difference between PUC and FMV is treated as a deemed dividend which in turn reduces the capital gain (FMV – ACB) that would otherwise have occurred on a hypothetical disposition.