POST-MORTEM TAX PLANNING: PIPELINE TRANSACTIONS, SUBSECTION 84(2) AND GAAR

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1. Introduction

A “pipeline” transaction is a form of post-mortem tax planning which has been commonly used to avoid the double taxation that may arise in circumstances where a taxpayer held shares of a private Canadian corporation as capital property at the time of his death. Some recent commentary from the Canada Revenue Agency (the “CRA”) in respect of the potential application of subsec. 84(2) of the Income Tax Act (Canada)¹ (the “ITA”) to pipeline transactions called into question the viability of such tax planning in certain situations. However, on April 17, 2012 the decision in MacDonald v. Canada² was released by the Tax Court of Canada whereby an assault by the CRA on another final reconciliation strategy on the basis of the application of subsec. 84(2) and the General Anti-Avoidance Rule (“GAAR”) was unsuccessful.

This article provides a brief overview of a typical pipeline transaction, a summary of certain CRA statements that have restricted the circumstances in which a pipeline transaction may be implemented, queries as to the legal validity of the CRA position and commentary on the effect of the recent case of MacDonald v. Canada on pipeline planning.

2. The Problem: Double Taxation

Under the ITA, during the year in which a taxpayer dies, a taxpayer is generally deemed to have, immediately before death, disposed of capital property for proceeds of disposition equal to the fair market value of the capital property at such time.³ Accordingly, a taxpayer who held shares of a private corporation as capital property at the time of death will recognize a capital gain in the final income tax return where the fair market value (determined

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1. R.S.C. 1985, c. 1 (5th Supp.), as amended. All statutory references are to the ITA, unless otherwise stated.
3. Subsec. 70(5).
immediately before death) of such shares exceeds the deceased’s adjusted cost base in the shares. The person who acquires the shares of the private corporation as a consequence of the taxpayer’s death (i.e., the executor of the estate of the deceased taxpayer) will have an adjusted cost base in the shares equal to the fair market value of such shares immediately before the taxpayer’s death.

The fair market value of the shares of the private corporation is based on the value of the corporation’s assets. However, there is no provision in the *ITA* that permits the shareholders of the private corporation to extract the corporation’s assets without additional shareholder tax. Consequently, the value of the assets of the private corporation may be taxed twice, once as a capital gain on the deemed disposition at death and the second as a dividend on the distribution of the assets (or substituted property) of the private company to its shareholder (i.e., the deceased’s estate).

3. The Potential Fix: Overview of a Pipeline Transaction

One method of avoiding double taxation has historically been to implement a pipeline transaction. Other methods are using subsec. 164(6) of the *ITA* whereby, in essence, deemed dividends are substituted for the capital gain arising on death within the first year of the estate and using the subsec. 88(1)(d) bump provisions.

The pipeline structure is intended to permit the estate of the deceased taxpayer to extract the assets (or substituted property) from the private corporation without triggering any additional tax (i.e., without giving rise to a deemed dividend under subsec. 84(2), which is described in more detail below). A typical pipeline transaction, for example, is implemented after the taxpayer’s death (i.e., after the deemed disposition at fair market value) and involves the estate incorporating a new corporation (“Pipelineco”) that will acquire the shares of the private corporation held by the estate. As consideration for the shares, Pipelineco will issue a non-interest bearing promissory note in an amount equal to the fair market value of the shares of the private corporation. The private corporation is subsequently wound-up into Pipelineco and all of its assets are transferred to Pipelineco. Pipelineco uses the assets received on the wind up of the private corporation to repay the promissory note to the estate. Pipelineco is dissolved.

4. The timing of the implementation of the various steps in the pipeline transaction may vary depending on the particular facts. For example, the estate may delay the wind up of the private corporation into Pipelineco...
4. The Concerns: Subsection 84(2) and 245(2) (“GAAR”)

Generally, under subsec. 84(2) of the ITA, where funds or property of a Canadian resident corporation have been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of the corporation’s shares on the winding-up, discontinuance or reorganization of its business, (i) the corporation is deemed to have paid a dividend on the shares of that class; and (ii) each person who held issued shares of that particular class is deemed to have received a dividend in an amount proportionate to the number of shares of that particular class held by each person immediately before the distribution or appropriation. The amount of the deemed dividend is equal to the value of the funds or property that is distributed or appropriated less the amount, if any, by which the paid-up capital of the shares of that class is reduced on the distribution or appropriation.

For many years the CRA issued favourable rulings implementing post-mortem pipeline planning. In these favourable rulings, apart from the CRA issuing the standard opinion that subsec. 84(2) would not apply to the proposed transactions, it also opined that the provisions of GAAR would not apply as a result of the proposed transactions to redetermine the tax consequences.

5. CRA Commentary on the Application of Subsection 84(2) and GAAR to Pipeline Structures

Such favourable rulings have been issued in situations where (i) the particular corporation would remain a separate and distinct legal entity (i.e., that the corporation was not wound-up into, or amalgamated with, another corporation) for a period from the date that its shares were transferred to the newly incorporated company; (ii) the particular corporation would continue to carry on its business in the same manner as before; and (iii) the note would be repaid, or the paid-up capital would be reduced, as the case may be, on a progressive basis.

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However, in document 2006-0170641E5, the CRA pointed out the fact that (i) the particular corporation would remain a separate and distinct entity for a period of at least one year; and that (ii) such corporation would continue to carry on its business in the same manner than before, were not “requirements” of the CRA but rather were elements present in the particular circumstances, which elements merely contributed to the CRA issuing favourable rulings.

At the 2009 Association de planification fiscale et financière (“APFF”) Conference Round Table on the Taxation of Financial Strategies and Instruments6 (the “2009 APFF”), the CRA was asked, among other things, to comment on the application of subsec. 84(2) to the following hypothetical fact-pattern:

A taxpayer is holding all of the shares of a taxable Canadian corporation (“ACO”), which is not a small business corporation, having a fair market value of $100,000 and a cost of $100.

ACO has cash totalling $100,000, no liabilities, $100 in capital stock and $99,900 in retained earnings.

As his death, the taxpayer is deemed to have disposed of his shares for $100,000 and realizes a capital gain of $99,900.

The estate of the taxpayer is deemed to have acquired the shares for an amount of $100,000, which corresponds to the cost and the fair market value of the shares for the estate.

The estate incorporates a new taxable Canadian Corporation (“BCO”) and subscribes to 100 common shares therein for $100.

The estate sells the shares of ACO to BCO for a price of $100,000 payable by the issuance of a non-interest bearing demand note.

ACO is then wound-up into BCO and all of its property is transferred to BCO.

Upon receipt of the property of ACO, including the cash totalling $100,000, BCO repays the note of $100,000, which is payable to the estate.

BCO is dissolved.

The estate gives the amount of $100,000, which came from ACO, to the heirs of the estate.

The CRA declined to comment on the application of subsec. 84(2) to the hypothetical fact pattern, in part, on the basis that such determination can only be made on a case-by-case basis. However, it did specifically point out that subsec. 84(2) requires the funds or property of a particular corporation to be have been distributed or otherwise appropriated in any manner whatever to or for the benefit

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of the shareholders on a winding-up, discontinuance or reorganization of the business of the particular corporation and in the favourable rulings the individual had ceased to be a shareholder of the particular corporation for at least one year before the receipt of the funds or property on the winding-up, discontinuance or reorganization of the business of the particular corporation. We may well have concluded from this statement that because of the one-year period, the CRA was of the opinion that the shareholder could not have been considered to have received the funds on the winding-up, discontinuance or reorganization of its business of the particular corporation and subsec. 84(2) was therefore inapplicable. Furthermore, the CRA distinguished the fact pattern presented from earlier rulings on two basic grounds, firstly that ACO does not appear to be carrying on a business prior to the death of the taxpayer and secondly that all of its assets consist of liquid assets.

In document 2010-0389551R3 a ruling on the following facts was sought. The deceased taxpayer was stated to be the sole shareholder of a corporation which had only liquid assets (possibly only cash) and had no investment activities and was inactive. The estate of the deceased requested a ruling in the context of the implementation of a pipeline strategy that the repatriation of the surpluses of the corporation would not give rise to a dividend under subsec. 84(2) of the ITA or GAAR. The CRA indicated that it was unable to provide the confirmation requested and, in fact, would opine that the proposed transactions would indeed, in the CRA’s view, give rise to a dividend treatment to the estate. The ruling request was withdrawn.

Further clarification as to the application of subsec. 84(2) to pipeline planning was sought at the CRA Round Table at the 2010 Canadian Tax Foundation Annual Conference, Round Table. It was pointed out to the CRA that if Pipelineco acquires the shares from the estate in consideration of the issuance of a promissory note and Pipelineco has never commenced to carry on business prior to distributing its property to the estate, it could hardly be said that the distribution to the estate has occurred on the discontinuance or reorganization of its business. Furthermore if the estate has not, as at the date of distribution by Pipelineco to the estate, passed any resolution to wind-up or dissolve the pipeline corporation, again the distribution to the estate has not occurred on the discontinuance or reorganization of its business. Focus was therefore put on Pipelineco in the context of subsec. 84(2). The CRA was asked to confirm that subsec. 84(2) would not apply to deem the estate or its beneficiaries
to receive a dividend on the sale of the shares of the corporation to Pipelineco under such circumstances. The CRA commented that, in its view, in considering the potential application of subsec. 84(2) to a series of transactions, the focus should be on whether the funds or property of the original corporation (not Pipelineco) have been distributed or otherwise appropriated in any manner whatever to, or for the benefit of, its shareholders (e.g., the estate) on the winding-up, discontinuance or reorganization of the business of the original corporation (not Pipelineco). In other words, it is the original corporation that would be deemed to have paid a dividend on its shares and a dividend would be deemed to have been received by the estate. Furthermore, the CRA distinguished the winding-up of a business from the winding-up of a corporation and noted that “circumstances falling short of the dissolution of a corporation may still result in the application of subsection 84(2).”

At the 2011 Society of Trust and Estate Practitioners Conference (the “2011 STEP Conference”), the CRA was again asked to comment on the application of subsec. 84(2) to a pipeline transaction. The proposed pipeline structure presented to the CRA was similar to the hypothetical fact pattern considered at the 2009 APFF, except that, instead of winding-up ACO (i.e., the original corporation), ACO pays a dividend to BCO (i.e., Pipelineco) in an amount equal to the principal of the promissory note (which, as indicated above, is equal to the fair market value of the shares of ACO) and BCO repays the promissory note owing to the estate with a cash payment. It was pointed out that, if subsec. 84(2) was to apply to result in a dividend to the estate as outlined in the Canadian Tax Foundation 2010 Round Table, this would seem to be an unfair and inappropriate result, leading to double taxation.

Again the CRA highlighted that the application of subsec. 84(2) to a particular set of facts necessitated a full and thorough review of all facts and circumstances but that the existence of the following facts might well in its view lead to the application of subsec. 84(2) and warrant dividend treatment (the “Dividend Elements”):

(1) the funds or property of the private corporation would be distributed to the estate in a short time frame following the taxpayer’s death; and/or

(2) the nature of the underlying assets of the private corporation would be cash and the private corporation would have no activities or business (referred to as a “cash corporation”).

The argument that the result of double taxation if subsec. 84(2) applied was met with the suggestion that this double taxation could be avoided with the implementation of the subsec. 164(6) capital loss carryback strategy.

The CRA revealed that its legal basis for the application of subsec. 84(2), if the Dividend Elements were present, lay in its view that like subsec. 84.1, subsec. 84(2) has anti-avoidance elements of broad scope which would have application, namely:

It is our view that these provisions, which have different requirements for application, target certain transactions that result in the extraction of corporate surpluses otherwise than by way of a dividend treatment (otherwise known as “surplus stripping”). Furthermore, we believe that section 84.1 and subsection 84(2) are not in conflict and that the potential application of both provisions must be considered in the context of pipeline transactions.

The CRA again focused on the Dividend Elements at the Canadian Tax Foundation Ontario Tax Conference in October 2011. At the same conference, Gwen Benjamin and Robert Martini co-authored a paper questioning the correctness of the CRA’s position concerning the application of subsec. 84(2) to the pipeline planning.

The author has the sense that despite the CRA’s response that the remedy for double taxation arising by application of subsec. 84(2) lies in subsec. 164(6), the CRA remains somewhat sympathetic to the choices that must be available and implemented to avoid double taxation in the post-mortem context, which sympathy the CRA does not share in other final reconciliation situations. Death does not necessarily strike with warning. Unless post-mortem tax planning is undertaken to minimize double taxation, catastrophic tax results can occur. Indeed the CRA recognizes that a choice of post-mortem planning techniques must be considered and implemented to mitigate these catastrophic tax results. At the 2011 STEP Conference, the CRA prefaces its Dividend Elements with the following comments:

It is our understanding that the choice of post-mortem planning technique would generally depend upon, amongst other things, the applicable capital gains and eligible and ineligible dividend tax rates in the particular situation, in addition to the existence of certain beneficial

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11. Supra, footnote 8.
corporate tax assets, such as the general rate income pool ("GRIP"), the refundable dividend tax on hand ("RDTOH") account and the capital dividend account ("CDA"). Accordingly, where a corporation would not have any of the aforementioned beneficial tax accounts, and where the corporation would be in a jurisdiction in which capital gains are afforded more favourable tax treatment than dividends, the pipeline strategy may be the preferred method as previously described.

The CRA specifically condones that, within limits, tax reconciliation can be the principal motivating factor in the post-mortem planning context and per se can drive the structure and form of the transactions. Viewed in this light, the challenge for the CRA is to walk a fine line between attacking those choices of dividend or capital gains transactions used by taxpayers outside the post-mortem context while justifying in law those condoned in the post-mortem context.

This line has been explicitly recognized and laid bare by Hershfield J. of the Tax Court of Canada in the recent case of *MacDonald v. Canada*,12 which dealt not with post-mortem final reconciliation planning but the exit of a shareholder in the context of emigration from Canada.

6. *MacDonald v. Canada*

The appellant in the *MacDonald* case was a heart surgeon who for several years had carried on his medical practice through his medical professional corporation ("PC"), first in Nova Scotia and then in New Brunswick. The appellant’s PC had a corporate surplus in excess of $500,000. As a result of bad investments, the appellant also had suffered substantial personal capital losses and personal capital loss carryforwards (or net capital losses). The appellant’s wife was a U.S. citizen. Having carried on his medical practice in Canada for over a decade through his PC, the appellant decided that he would emigrate to the United States.

The appellant’s accountant advised him that his departure from Canada could be problematic for while a deemed disposition of his PC shares would trigger capital gains in Canada, the United States would not recognize any increase in the cost of those PC shares he retained. Accordingly, should he continue to hold the PC shares after emigration and later repatriate the corporate surplus as a resident of the United States, the U.S. would tax him on the basis of the amount actually received by him including the amount up to the fair market value of the shares on the date of his emigration already

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taxed by Canada. A sale of the PC shares to a third party before emigration was therefore his only remedy. Unable to sell his PC shares to another physician, the appellant accepted a plan whereby he sold the PC shares to his brother-in-law ("J.S.") for the current fair market value of the shares and received a promissory note in principal amount equal to the purchase price. The appellant was able to shelter the capital gain so triggered on the sale of the PC shares by application of his capital losses and net capital losses. J.S. then transferred the newly purchased shares of the PC (no longer a medical professional corporation but rather an investment company ("IC")) to his newly incorporated company ("Holdco") for shares of, and a promissory note from, Holdco. IC declared dividends to Holdco. Holdco repaid the promissory note to J.S. J.S repaid the promissory note to the appellant. The appellant then left for the United States.

At trial the Minister abandoned his argument that the PC share sale funded by way of the series of related transactions with funds provided by the PC was a sham. Rather the Minister argued that a dividend had been received by the appellant on the basis of the application of subsec. 84(2) or s. 245.

However, nowhere did the Minister specifically identify the “tax benefit” for purposes of s. 245. Implicitly, the benefit had to be understood to be the use of capital losses and loss carry forwards claimed by the appellant that would not have applied had the appellant received a dividend as opposed to the capital gain he reported.

7. Subsection 84(2)

Hershfield J. found that since the sham argument had been abandoned by the Minister, the legal validity of each part of the transactions had been admitted by the Minister. Therefore, at law, there could be no dispute that the appellant did not receive the funds qua creditor as the documents stated and not qua shareholder as the Minister proposed. A creditor was simply not caught by subsec. 84(2).

The Minister resorted to three arguments concerning subsec. 84(2); firstly that the terms of subsec. 84(2) “in any manner whatever” should encompass the payment by the PC to the appellant; secondly, that the case of *RMM Canadian Enterprises Inc. v. Canada*13 decided on similar facts, caught the appellant within the net of subsec. 84(2) and thirdly, that subsec. 84(2) should be given a purposive (as

opposed to literal) construction, making it an anti-avoidance provision, in and of itself.

Hershfield J. gave short shrift to the argument that the terms “in any manner whatever” somehow encompassed the payment to the appellant. The manner of distribution of the PC’s property was by way of dividend to Holdco. The terms of subsec. 84(2) focus on the manner of effecting the distribution to the shareholder (namely Holdco) and were not capable of being used to redirect to whom the distribution was paid. There was no “deeming rule” in subsec. 84(2). That subsec. 84(2) lacked the express language appearing in subsec. 84(3) to deem a dividend to arise where the company directly or indirectly financed the payment of the purchase price supported the conclusion that subsec. 84(2) could not be read to apply catch the share price paid by a purchaser.

The Minister attempted to persuade the court that a more expansive interpretation of a specific provision was to be preferred to a finding of application to the facts of GAAR, as had happened in RMM Canadian Enterprises Inc. v. Canada.\footnote{Ibid.}

In RMM Canadian Enterprises Inc., Bowman J. had given the terms of subsec. 84(2) a wide and expansive interpretation and found it to apply where a buyer of shares was introduced as a convenient intermediary to allow the value of the acquired company to end up in the hands of a former shareholder, avoiding Canadian withholding tax. However, in contrast and on similar facts, the court in the earlier case of McNichol v. Canada\footnote{[1997] 2 C.T.C. 2088, 1997 CarswellNat 33 (T.C.C.). In the McNichol case, four lawyers who owned a company (“Bec”) whose only asset was $332,000 cash, sold shares of Bec for cash proceeds of $300,000 to another company} had found not on the application of

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14. Ibid. In the RMM Canadian Enterprises Inc. case, Equilease Corporation (“Equilease”), a U.S. resident, had a wholly-owned Canadian subsidiary, Equilease Canada (“EL”). In turn, EL had a Canadian subsidiary, Equilease Canada Limited (“ECL”). EL and ECL had been in the leasing business but, at the relevant time, that business had wound-down, leaving combined cash of some $3,000,000, entitlement to an income tax refund of $1,500,000 and a leasing portfolio worth some $140,000. Equilease could have wound-up the Canadian corporations and incurred Canadian withholding tax of $400,000 or alternatively, sold its shares of EL to a third party triggering a capital gain but claiming an exemption from Canadian tax under the Canada-United States Income Tax Convention (1980). It chose the latter course, selling its EL shares to RMM, a newly incorporated corporation whose only shareholders were a partnership formed by a “friendly” group of U.S. individuals. On the same day as the purchase of EL shares by RMM, RMM caused EL to commence winding-up procedures and caused itself and ECL to amalgamate. RMM repaid the bank loan which it had taken out to pay the purchase price of the EL shares, the repayment being made by funds from EL and ECL.

15. [1997] 2 C.T.C. 2088, 1997 CarswellNat 33 (T.C.C.). In the McNichol case, four lawyers who owned a company (“Bec”) whose only asset was $332,000 cash, sold shares of Bec for cash proceeds of $300,000 to another company
subsec. 84.1, but rather on the application of GAAR. With respect to the seeming conflict between these two cases, Hershfield J. concluded:

[59] With the greatest respect then, I do not agree that the distinctions drawn in RMM ought to limit the scope of the decision in McNichol. In my view, the McNichol approach which was to look to section 24 when subsection 84(2) does not apply on a strict construction of the language is the correct approach.

On the implications of potential use of corporate funds to finance an exit strategy, Hershfield J. was reminded that in the McNichol case, Bonner J. did not consider knowledge that the purchaser might implement a series of transactions structured to enable access to corporate funds as a financing mechanism to be equivalent to an obligation to undertake those events. In any event, Hershfield J. was of the opinion that for the purposes of subsec. 84(2), a structure undertaken by a shareholder, while a shareholder, to allow access to corporate funds is not the same as being in receipt of those funds as a shareholder while no longer being a shareholder.

The Minister finally argued that a purposive as opposed to a literal construction of subsec. 84(2) should govern. The original purpose of subsec. 84(2), as it was brought in by legislation affecting post-1971 dispositions of capital property, was to prevent capital gains treatment. Inherent in this argument was the CRA’s position that the intent underlying subsec. 84(2):

[63] . . . was, and it remains, an anti-avoidance provision the language of which must be construed more broadly to ensure dividend treatment when a taxpayer indirectly receives the retained earnings of a company that he was entitled to receive as a shareholder.

Hershfield J. again remained unconvinced of the underlying intent of subsec. 84(2) but rather perceived the Minister’s position as being an attack on surplus stripping transactions per se, a GAAR issue. He simply could find nothing in the language of subsec. 84(2) that supported the anti-avoidance purpose envisaged by the Minister. On the contrary, the classic surplus strip was subject to a specific anti-avoidance section, s. 138A of the old, pre-1972 Act. Section 138A was replaced by s. 247 in 1988, which was replaced with s. 245 under the current ITA.

owned by one of their clients (“Beformac”). Beformac financed the purchase price with a bank loan. The capital gain in each of the lawyers’ hands was sheltered by the $100,000 capital gains exemption. Beformac and Bec were amalgamated a couple of days after the purchase and sale of the shares when the cash of the amalgamated company was used to repay the bank.
8. The Pipeline Reference

Before addressing whether GAAR applied to the circumstances before him, Hershfield J. felt compelled to comment on another aspect of the Minister’s anti-surplus stripping position. The appellant had pointed out that in an analogous tax-planned surplus strip strategy referred to as post-mortem pipeline tax plans, the CRA had issued favourable advance income tax rulings.

Hershfield J. immediately recognized the somewhat conflicting position that the CRA found itself in administering subsec. 84(2) “where abuse is not the sole focus of the analysis” (at para. 71), namely in allowing choice between use of capital gains and dividends in the post-mortem tax planning context in order to combat double tax but not in other circumstances.

The court continued:

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.
These statements clearly have left little room for doubt that any notion that a normal pipeline transaction would be caught by subsec. 84(2) simply does not exist. But what about subsec. 245(2)?

9. GAAR

The MacDonald case was not one where the tax benefit was patently evident from the outset, in law or indeed according to Hershfield J., in the record before the court.

The appellant argued that, in accordance with Canada Trustco Mortgage Co. v. Canada\(^\text{16}\) and reiterated in Copthorne Holdings Ltd. v. Canada\(^\text{17}\), the existence of a tax benefit might be established by comparing the taxpayer’s situation with that which might reasonably have been carried out but for the existence of the tax benefit. In this case, the appellant would have left Canada owning the PC shares. He might have triggered the accruing capital gains on the PC shares and made use of his capital losses to offset against the triggered capital gains. On this basis, no tax benefit would in fact have existed. A continuation of this comparable would have seen the appellant causing the PC to be wound-up while he was a resident of the United States. In such a case, the Minister would have been assessing on the basis the tax benefit was the elimination of Part XIII tax. The only benefit that the Minister identified was the creation of a capital gain enabling the use of capital losses which resulted in a reduction of tax payable.

Hershfield J. rightly highlighted that the selective identification by the Minister of one particular tax benefit as opposed to another with an element of arbitrariness was unsettling in this case, but agreed that the proper focus of the GAAR analysis was the tax benefit assessed by the Minister, namely the creation of a capital gain enabling the use of capital losses which resulted in a reduction of tax payable. The issue subject to the GAAR analysis was squarely to be focused on use of capital losses (as opposed to surplus stripping), as set out in paras. 105 and 106:

[105] The object and spirit of a particular provision of the Act can only be said to have been abused in relation to affording a particular unintended tax benefit. The issue here is then about the objectives and policies of the Act that relate to the limited use of capital losses, not about some general theme concerning access to corporate retained earnings other than a dividend. That is, the asserted unintended tax


benefit created by the strip — *the use of capital losses* — should be the focus of the analysis.

[106] Accordingly, I will proceed on that basis.

Having pinpointed the tax benefit to the appellant, it was then necessary to answer the question whether the transaction giving rise to the tax benefit was “an avoidance transaction”. Accepting that the share sale gave rise to the tax benefit, it was clear that the appellant implemented that sale while still a resident of Canada for the *only* purpose of obtaining that tax benefit. The transaction was accordingly “an avoidance transaction”.

The last component of the GAAR review was framed as a response to the question: “Was the PC share sale abusive in creating a capital gain which would be off-set by capital losses?” However, the Minister insisted that the correct question to be answered by the court was: “Was the PC share sale abusive in Avoiding Dividend Treatment on the Distribution of Retained Earnings?”

### 10. Was the PC Share Sale Abusive in Creating a Capital Gain Which Would be Off-Set by Capital Losses?

The real question as seen by Hershfield J. was whether s. 3 of the *ITA* had been abused since that section prevents using capital losses to shelter anything but capital gains. In light of the fact that the *ITA* tends to be permissive in the variety of ways to use capital losses, some of them perhaps somewhat artificial, he was simply unable to find that any abuse of s. 3 had arisen by the appellant’s sale of the PC shares to his brother in-law. That the appellant achieved the same result as if he had departed from Canada owning the PC shares, albeit by using different means, confirmed the result. Briefly put:

[123] . . . In this case, it just cannot be said that the purpose of the Act, to limit the use of capital losses to off-set capital gains, is frustrated by the surplus strip.
11. Was the PC Share Sale Abusive in Avoiding Dividend Treatment on the Distribution of Retained Earnings?

Nevertheless, Hershfield J. felt compelled to deal with the question framed by the Minister.

He repeated that insisting that maintenance of a dividend regime (as opposed to a capital gains regime) on any winding-up or discontinuance of a business would have required that subsec. 84(2) be found to operate beyond its express language.

What the Minister is attempting to achieve is to have a blanket statement that a surplus strip per se will be considered abusive because it frustrates the operation of two different tax regimes in the ITA, irrespective of the nature of the tax benefit relating to the transaction. Essentially, this puts the cart before the horse:

[132] . . . said differently, neither subsection 84(2) nor GAAR can be used to fill a gap between two approaches to taxing an individual shareholder’s realization of accumulated after-tax funds in a company. There must be more. Subsection 84(2) does not employ language that attacks tax abuse issues relating to surplus strips. Section 245 does. As stated earlier in these reasons — it is a better litmus test to identify strips that offend the spirit and objects of the Act as a whole. Unless an abusive tax benefit results from the avoidance series of strip transactions, the tax result stands undiminished. Avoidance transactions alone do not frustrate the principles set out in the Duke of Westminster.

The appellant won the day. The Minister has filed an appeal in the MacDonald case.

12. Commentary

What implications can be drawn from the MacDonald case at the Tax Court level decision with respect to post-mortem pipeline planning?

1. In the construction of subsec. 84(2) of the ITA, the principles of the Canada Trustco Mortgage Co. case18 reign:

[10] when the words of a provision are precise and unequivocal, the ordinary meaning of the words play a dominant role in the process.

On this basis, the courts are moving away from an expansive construction of subsec. 84(2) isolating the decision in decision in the RMM Canadian Enterprises Inc. v. Canada case to very limited facts.19 There is nothing under subsec. 84(2) or GAAR

18. Supra, footnote 16.
that requires a taxpayer to be taxed under the dividend (rather than capital gains) regime.

However, what we are left with is the following: a case that found that subsec. 84(2) and GAAR was applicable (RMM Canadian Enterprises Inc. v. Canada case); a case that found that subsec. 84(2) was not applicable but that GAAR was applicable (McNichol case) and a case that has swathed a third path through the forest finding that neither subsec. 84(2) nor GAAR applies (MacDonald case), all cases having similar facts, all decisions from the same court.

2. As reiterated by the Supreme Court of Canada in the Copthorne case, “Taxpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability (see Duke of Westminster)”\(^{20}\) and again, we are reminded of the fact that consistency, predictability and fairness in tax law are to be strived for and for this reason, “the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear.”\(^{21}\)

One can only conclude that the abusive nature of a pipeline transaction has escaped tax practitioners and has indeed been far from clear.

3. It is necessary to determine what tax benefit is derived from a post-mortem pipeline transaction. This may vary depending on the circumstances of each case. However, if the tax benefit is simply maintenance of a status quo, \(i.e.,\) that the estate accepts the consequences of a deemed disposition under subsec. 70(5) of the ITA of the original shares of the particular corporation on death of the shareholder and is free thereafter to deal with such shares as the estate decides, it is difficult to comprehend how maintenance of a status quo could be viewed as being abusive, particularly in light of the fact that the CRA condones choices in post-mortem planning between dividends and capital gains. Additionally, in the surplus strip arena, subsec. 84.1 has been specifically drafted to exclude application to shares owned by an estate with a hard adjusted cost base.

\(^{20}\) Supra, footnote 17, para. 65.

\(^{21}\) Copthorne, supra, at para. 68.
4. The fact remains that surplus stripping is for the CRA at the centre of GAAR issues at Committee and litigation. The MacDonald case may not have facts and equities which engender it to be the standard-bearer for the CRA position of an integrated corporate/shareholder tax system such that a surplus strip *per se* can be said to be an abuse or misuse of the spirit and object of the *ITA* read as a whole. Nevertheless, it is too important a case for the CRA not to appeal but is unlikely, whatever the outcome, to be the last CRA attack on surplus stripping.