TAX COURT OF CANADA

SAFE INCOME—THE DANGEROUS IMPACT OF FUTURE TAXES

626468 New Brunswick Inc. v. The Queen
2018 TCC 100

KEYWORDS: SAFE INCOME ■ CAPITAL GAINS ■ CONTINGENT LIABILITIES ■ TAX LIABILITY

Introduction

In *626468 New Brunswick Inc.*,[17] the Tax Court of Canada adjudicated on the question of whether the computation of safe income pursuant to section 55 (as it existed prior to the 2016 amendments to the Act) is made before or after tax. The court decided in favour of the minister and held that contingent taxes have to be taken into account in computing the amount of safe income.

Background

Rodney J. Gillis, a litigation lawyer, personally owned an apartment building in New Brunswick ("the property"), which an unrelated party became interested in purchasing. Desiring to dispose of the property in a tax-efficient manner, Mr. Gillis consulted an accounting firm to devise a tax plan. The proposed tax structure entailed the incorporation of two companies, Tri-Holdings Ltd. ("the property company") and 626468 New Brunswick Inc. ("the appellant"), and was implemented through the following transactions:

1. In November 2006, Mr. Gillis transferred the property to the property company on a tax-deferred basis and elected at the cost amount of the property pursuant to subsection 85(1). Mr. Gillis received common shares in the property company with nominal PUC and ACB.
2. On November 30, 2006, Mr. Gillis transferred his four common shares in the property company to the appellant in exchange for four common shares of the appellant. The transfer to the appellant was also effected on a tax-deferred basis pursuant to subsection 85(1), with the elected amount being the nominal ACB of the property company common shares. Accordingly, as at November 30, 2006, Mr. Gillis held 100 percent of the equity in the appellant, which held 100 percent of the equity in the property company, which in turn held the property.
3. Following the two rollovers, the property company disposed of the property to an unrelated party, realizing a capital gain and recaptured capital cost allowance. The non-taxable portion of the capital gain was added to the

17 *626468 New Brunswick Inc. v. The Queen*, 2018 TCC 100.

> property company's capital dividend account.[18] The property company in several stages triggered (by PUC increases) both taxable dividends and dividends that were elected to be capital dividends.[19] As a result of these deemed dividends, the ACB of the appellant's shares in the property company increased by the amount of the deemed dividends pursuant to paragraph 53(1)(b).

Two favourable tax consequences were intended to follow from the above transactions. First, the deemed dividends were not immediately taxable to the appellant because it was entitled to a deduction in respect of the deemed dividends pursuant to subsection 112(1). Second, the bump in the ACB of the property company shares meant that an ultimate disposition of the property company shares held by the appellant would yield a capital gain that would be lower by the amount of the deemed dividends.

On December 29, 2006, the appellant sold its shares in the property company to Wilshire Technology Corporation, for an amount that was almost the same as the ACB of the common shares of the property company (after the increases in ACB arising from the deemed dividends).

On December 31, 2006, the property company was continued into British Columbia and entered into an agreement to acquire software. The property company deducted capital cost allowance in respect of the software acquisition, using the deduction to offset the taxable income arising from the sale of the property. The minister challenged the deduction. This issue with respect to the property company was under objection and unresolved the time of the trial.

For its 2006 taxation year, the appellant deducted the taxable dividends from its taxable income in accordance with subsection 112(1). The minister reassessed the appellant on the basis that the deemed dividends received by the appellant exceeded the property company's safe income, thereby giving rise to a taxable capital gain under subsection 55(2). The minister's position was that in computing safe income at the time the dividends were paid, an amount was required to be deducted on account of the taxes that would be required to be paid by the property company if it had not acquired the software or if the software did not provide a deduction that reduced the taxes payable.

The Issue

Subsection 55(2), as it read at the relevant time, provided that a dividend would not be treated as a dividend but would be recharacterized as a capital gain if one of the purposes of the dividend (or one of the results, if the dividend arose under subsection 84(3))

18 See subsection 83(2).

19 The taxable dividends were deemed dividends pursuant to subsection 84(1).

> 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.[20]

The term "safe income," which does not appear in the Act, has generally been adopted by the tax community as meaning the "income earned or realized" that is available for the payment of dividends and that will not result in the application of subsection 55(2).

The appellant conceded that the other requirements of subsection 55(2) were met, and the only question before the court was whether the amount of the deemed dividends exceeded the "income earned or realized" test for the purpose of subsection 55(2). More particularly, the issue as identified by the court was whether in calculating safe income, the taxes that would be payable by the property company as a result of the sale of the property were required to be deducted in computing safe income.

The appellant submitted that the plain words of the provision did not provide for the deduction of taxes in computing safe income. Further, paragraph 55(5)(c), which provides a definition of "income earned or realized" by a corporation for the purpose of subsection 55(2), specifically excludes the application of certain deductions and makes no reference to the deduction of taxes. This, the appellant contended, can be contrasted with other provisions where Parliament has "clearly referred to after-tax income by using specific terms such as 'tax-paid undistributed income' and 'tax paid surplus on hand.'"[21]

The appellant also argued 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 [the property company] had no tax to pay, the safe income should not have been reduced.[22]

The Crown relied on the decision of the Tax Court in *Deuce Holdings Limited v. The Queen*,[23] which held that "income earned or realized" refers to after-tax income, and that on the basis of *Canada v. VIH Logging Ltd.*,[24] the calculation of safe income had to be completed immediately before the dividends were triggered.

20 Subsection 55(2) as it read prior to amendments enacted by SC 2016, c. 7, section 5(1), applicable to dividends received after April 20, 2015.

21 *626468*, supra note 17, at paragraph 19.

22 Ibid., at paragraph 20.

23 97 DTC 921 (TCC).

24 2005 FCA 36.

The Decision

The court was of the view that the question of whether tax should be deducted in computing safe income had already been decided by a previous judgment of the court; specifically, it said,

> [t]his question was decided by Justice Bell in *Deuce Holdings Ltd.* Justice Bell stated at paragraphs 28 to 32 of his reasons that in calculating the amount of safe income, taxes had to be extracted.[25]

The court did not accept the appellant's argument that taxes have to be calculated at the end of the year, at which point the appellant did not have a tax liability, and therefore no reduction in safe income was warranted. The court rejected this position, noting that safe income must be computed at the safe-income determination time, which mandates that the property company's safe income had to be determined immediately before the first deemed dividend (that is, December 13, 2006). Accordingly, the safe-income computation as of that date would have taken into account the tax liability and yielded a lower safe-income amount.

Analysis

At first blush, *Deuce Holdings* may appear to be on all fours with the issue to be decided in this case. This may have led the court away from applying the "unified textual, contextual and purposive approach"[26] to the interpretation of subsection 55(2) that the Supreme Court of Canada has ruled should be applied in all cases of statutory interpretation.

Simplified, subsection 55(2) requires the court to determine (1) whether one of the purposes of the dividend was to effect a significant reduction of the capital gain that, but for the dividend, would have been realized on a disposition at FMV of the shares of the corporation; and, if so, (2) whether the gain that was reduced could reasonably be considered to be attributable to anything other than safe income.

In *Deuce Holdings*, the taxes were actually paid by the dividend-paying corporation. The tax payment was an actual cash payment out of the corporation, which reduced the value of the corporation by reducing the corporation's assets. Further, as part of the safe income had been paid out of the corporation as taxes, the amount of the capital gain that could be attributed to safe income was reduced. Put simply, if safe income is spent, whether on other dividends, taxes, or other expenditures, it is not available to contribute to the capital gain. However, in *626468*, the appellant's position was that the taxes were not yet due at the safe-income determination time, and it was expected that they would never become due. In these circumstances, it is reasonable to conclude that the full amount of the safe income was available to

25 *626468*, supra note 17, at paragraph 28.

26 *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, at paragraph 70.

contribute to the capital gain that would have been realized on a sale of the shares in the absence of the dividends.

Indeed, the question asked by former subsection 55(2) was whether the gain that was avoided by the payment of the dividend was attributable to anything other than safe income. In the facts under consideration in *626468*, the property company had disposed of all of its assets. All that remained was the cash representing the income that was earned by the property company on the sale of the property. Effectively, there was nothing else in the property company other than safe income to contribute to the gain that was avoided by the dividend.

The particular wording of subsection 55(2) (as it then read), and the mischief that it was designed to address, support this interpretation. The typical abuse that subsection 55(2) was designed to prevent was the situation where a corporation owned property with an accrued but unrealized capital gain. Assuming that the shares of the corporation had a low ACB, a sale of the shares of the corporation would also trigger a capital gain. Finance did not want the corporation to pay an intercorporate dividend based on the value of the accrued gain in the property and thereby either

- reduce the value of the corporation and reduce the underlying gain in the shares (in the case of a cash dividend); or
- increase the ACB of the shares, thereby reduce the underlying gain in the shares (in the case of a stock dividend or a PUC increase), and thus avoid the gain inherent in the value of the underlying property through a sale of shares and a dividend.

This mischief is not present when the corporation does not own any assets with accrued gains.

The difference in treatment between circumstances where a tax liability has been paid (as in *Deuce Holdings*), or it is expected that the tax liability is fully payable, and circumstances where the parties to the transaction do not expect taxes to be payable is highlighted by a quotation from the decision of Bell J in *Deuce Holdings*:

> Unhappily, it seems that one must journey beyond the words in section 55 in order to determine whether the computation [of safe income] 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 the 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.[27]

27 See *Deuce Holdings*, supra note 23, at paragraph 30 (emphasis in original).

Bell J's analysis demonstrates that he is addressing taxes that are paid or that the parties expect to be fully payable. While Bell J is correct that no purchaser would pay a price for a share without taking into account a known payment or liability, a purchaser would certainly not expect to reduce the purchase price for a share on account of a notional tax that neither the purchaser nor the vendor expected to be paid or to become due. Indeed, the vendor in such circumstances would insist that there be no reduction in the share purchase price. The fact that the parties to a transaction do not reduce the share purchase price to reflect a notional tax amount is solid evidence that the income earned by the corporation, unimpaired by the notional tax liability on that income, is contributing to the value of the shares.

We suggest that the correct methodology for determining the impact of contingent taxes on the computation of safe income should be no different from the treatment of any other contingent liability payable out of income. To the extent that the contingent liability (taxes or otherwise) reduces the purchase price for the shares, it obviously reduces the contribution of the safe income to the gain that would otherwise be realized on the sale of the shares and should reduce safe income for the purposes of former subsection 55(2). Equally, to the extent that the contingent liability does not reduce the purchase price for the shares, it does not reduce the contribution of the safe income to the gain that would otherwise be realized on the sale of the shares and should not reduce safe income for the purposes of former subsection 55(2) (and now subsection 55(2.1)).

The decision of the Tax Court is under appeal, so the Federal Court of Appeal will have the opportunity to consider the unified textual, contextual, and purposive approach to the computation of safe income.

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BIBLIOGRAPHIC INFORMATION
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