Cases dealing with discretionary dividend shares and other related matters

Tax Law for Lawyers
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Champ
1982 (FCTD) - L

> H owned 450 class A voting

> W owned 225 class B voting

> all shares had a par value of $1.00 each

> articles stated that “dividends may be declared and paid according to the amounts paid on the shares”

> dividends paid on B’s only

> breach of conditions of shares and H diverted his pro rata entitlement to his wife

> 56(2) applied
  — a payment or transfer of property
  — pursuant to the direction, or with the concurrence of, a taxpayer
  — for the benefit of the taxpayer or the recipient
  — if payment had been made to the taxpayer, it would have been included in his or her income
McClurg
1990 (SCC) - W

> class A 400 held by each of 2H, voting, discretionary dividend entitlement, 2H were directors

> class B 100 held by each of 2W, non-voting, discretionary dividend entitlement

> dividends paid on class B only

> Are discretionary dividend clauses valid as a matter of corporate law?

> for:
  — sbca derogates from common law presumption of equality
  — the fact that directors consider the identity of the shareholders is not a breach of their fiduciary duty to the corporation
  — it would be paternalistic in the extreme to invalidate the articles

> against:
  — the principle that shareholder rights must attach to the shares cannot be circumvented by shareholder agreement
McClurg (cont’d)

> 56(2) should not generally apply to dividends
> until a dividend is declared, the profits belong to the corporation
> in declaring dividends, directors act in their capacity as directors, not in their personal capacity
> directors act for company, NOT for shareholders (see BJ Services Company Canada [2003] TCC 900 regarding valid corporate expenses)
> if a distinction is to be made under 56(2) between arm’s and non-arm’s length transactions, it should be when the non-arm’s length shareholder has made no contribution to the corporation
> discretionary dividend shares effectively convert a company into a discretionary trust
Neuman
1998 (SCC) - W

> H - had section 85 preferred and acquired 1 common share for $1.00

> W - acquired 99 class F for $99.00

> W received a dividend of $14,800 and immediately lent the funds on a demand, non-interest basis to H

> there is nothing in the Act which suggests an overall intention to prevent income splitting

> 56(2) is a specific tax avoidance provision and not a general provision against income splitting

> taxpayer must have a pre-existing entitlement to dividend income before 56(2) can apply

> Dickson should not have mentioned Wilma McClurg’s contribution
Ferrel
1999 (FCA) - W

> Ferrel was settlor and sole trustee of a trust for his 2 minor children

> trust owned non-voting equity shares, and Ferrel owned voting non-equity shares, in a holding company

> trust agreed to provide management services to the holding company

> Ferrel agreed to provide services on behalf of the trust for such remuneration as Ferrel and the trust should from time to time determine

> Ferrel agreed to be president and secretary of the company

> the trust retained approximately $150,000 per year

> 56(2) as a tax-avoidance provision is subsidiary in nature, it exists to prevent the avoidance of tax, not simply to double the tax normally due

> when the taxpayer himself has no entitlement to the payment made, 56(2) is subject to an implied condition, namely that the payee not be subject to tax on the benefit he or she received
Ferrel

- settlor
- sole trustee of trust
- president and secretary of Holdco
Kieboom
1992 (FCA) - L

> incorporated in 1976 - 9 shares to H, 1 share to W

> 1980, W purchased 8 non-voting class A for $1.00 each

> 1981, 8 non-voting class A to each of 3 kids for $1.00 each

> 3 issues:
  (i) disposition under 245(2)(c) & 69(1)
  (ii) attribution to H under 74(1)
  (iii) 73(5) rollover to children did not apply

> transfer “is one of the widest terms that can be used”

> property is the “most comprehensive of all the terms that can be used … descriptive of every possible interest which a party can have”

> by the issuance of the additional shares, the value of the shares held by the taxpayer was diminished

> he divested himself of certain rights to receive dividends should they be declared

> the 73(5) rollover did not apply because there was a transfer of property which was later turned into shares
Shepp  
1999 (TCC) - W

> H had 79 common shares, W had 1 common share  
> H exchanged 17 common shares for class B, non-voting  
> class A/class B shared equally on dissolution  
> class A can receive dividends to the exclusion of class B  
> H transferred 17 class B shares to trust under 73(5)  
> arm’s length agreement to acquire all shares  
> class B’s amended to make them convertible into class A’s  
> not at arm’s length with trust (query new 251(1)(b))  
> 2 issues (i) was there a value shift  
> (ii) if so, was there a disposition

> arm’s length offer establishes value  
> there was no significant value shift  
> Court considers the CCRA approach to “disposition” to be suspect  
> Kieboom was based on repealed 245(2)(c)

> reference to Winram - estate tax case  
> deceased had 9 of 10 voting shares  
> W had 1 voting and 990 non-voting  
> class A and class B were discretionary dividend shares  
> Court held that 9/10 of value with H  
> Winram involved a notional market - Shepp did not
Romkey
1999 (FCA) - L

> class A held by two Hs, voting preference
> class B non-voting common shares held by two Hs, Ws, kids’ trusts

> trust accounts in disarray
  – failed to establish family allowance money used to establish trusts
  – Minister conceded that he would lose if kids’ money used

> at the time of the initial dividends, the trusts' shares had not been paid-up
  – taxpayer argued he had no equity and therefore no property could have been transferred

> a transfer of property was accomplished in two ways:
  (1) a portion of taxpayer's equity; and
  (2) divestiture of certain rights to receive dividends should they be declared

> taxpayer forewent the right to receive an increased measure of any future dividends declared
Paul’s Case
(Laflamme)
2008 (TCC) - W

> Class D – no votes, nominal equity, each convertible into 1 million Class A
> Class E – 100 votes per share, nominal equity
> Class A – 1 vote per share, almost all equity
> trust – Laflamme was controlling trustee and a capital beneficiary
> transaction – trust transferred 20 Class A shares for $15 million
> taxpayer owned
  – 500 Class E shares with nominal equity and 100 votes per share (50,000 total votes)
  – 10 Class D shares with nominal equity and no votes but each Class D share convertible into 1 million Class A shares
> family trust of which taxpayer was the controlling trustee and a capital beneficiary owned
  – 100 Class A that have all the equity and 1 vote per share (100 total votes)
> total value of all shares is $75 million
> trust transferred 20 Class A shares for consideration of $15 million
> CRA said the Class A shares were only worth a nominal amount, because the taxpayer could swamp the Class A shares by converting his Class D shares
> therefore the taxpayer conferred a benefit on the trust
> in *Corner Brook Pulp & Paper* Bowman J., ignored a way below-market contact to supply electricity to the corporation’s wholly-owned parent in determining the value of the shares of the subsidiary on the basis that the parties could “get rid of the contract…with the stroke of a pen. That is not a legal conclusion nor is it a matter of appraisal expertise. It is just plain common sense.”
> to convert the Class D shares would undermine the estate freeze and that was obviously not the intention of the taxpayer – so it should not be assume that the conversion right would ever be exercised
> Court viewed the Class A shares as having a value that would be diminished if the conversion occurred, rather than having a value that was already eroded because of the conversion feature
Lacterman pleadings – simplified
2009 – 498-495 (IT)G - discontinued

> on death of parents, voting shares transferred to children

> CRA alleged that the voting shares were worth 50% of value of all shares
Dustin pleadings – simplified
2009 – 1152(IT)G – appeal allowed on consent

> result of an estate freeze
> father and trust sold shares, with almost all value allocated to non-voting shares
> CRA alleged voting shares were worth at least 1/3 of total share value and purchaser was not dealing at arm’s length with vendors with respect to allocation of purchase price
Shell
1999 (SCC) - W

> weak currency loan
>
> courts must be sensitive to the economic realities of a particular transaction rather than being bound to what first appears to be its legal form - but there are at least two caveats to this rule

  – economic realities cannot be used to recharacterize a taxpayer’s bona fide legal relationships - legal relationships must be respected in tax cases

  – a searching inquiry for economic realities or object and spirit cannot supplant a court’s duty to apply an unambiguous provision of the Act

> absent a specific provision to the contrary, it is not the court’s role to prevent taxpayers from relying on the sophisticated structure of their transactions - unless the Act provides otherwise a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done
Will - Kare Paving
2000 (SCC) - L

> meaning of “sale” for purposes of class 29 and itc’s
> asphalt plant - 75% used in contracts for work and materials - 25% sold to third parties
> under sale of goods law title to asphalt used in work and materials contracts passed by accession not by sale
> absent express direction that an interpretation other than that ascribed by settled commercial law be applied, it would be inappropriate to do so
> the Act is not a commercial code in addition to a taxing statute
> the technical nature of the Act does not lend itself to broadening the principle of plain meaning to embrace popular meaning - the word sale has an established and accepted legal meaning
> the provisions at issue are clear and unambiguous and reference to economic realities is not warranted

dissent:
> the millions of taxpayers who are not lawyers cannot be expected to reach for Benjamin’s Sale of Goods…in the assessment of their own income tax liability
> if two contracts had been used, one for materials, the other for work, the taxpayer would have succeeded
Citibank
2002 (FCA) - W

> term preferred shares

> preferred shares convertible into number of common shares equal to:

\[
\frac{\text{issued price of preferred}}{\text{fmv of common at conversion}}
\]

> (a) (iii) the issuing corporation...provides...any form of guarantee, security or similar indemnity or covenant...with respect to the shares

> there is an ambiguity, so legal technical meaning is correct approach
Hayes
2003 (TCC) – L 2005(FCA) L (on different basis)

> taxpayers invested in convertible hedges with one taxpayer selling a security short and a related taxpayer acquiring a long position in a security convertible into the security that the other taxpayer sold short

> each taxpayer executed a cross-guarantee on his or her trading account

> a high – income spouse would sell short and deduct the associated borrowing fees and dividend compensation payments, while a low-income spouse would acquire the convertible security which generated current income

> in addition, taxpayers would rely on the administrative position that gains or losses from short sales were on income account while gains with respect to the long positions were capital gains

> the convertible hedge itself was the investment and not its components

> the taxpayers were engaged in a profit-making scheme and it was not correct to tax one transaction separately from the context of that scheme

> the court found that our taxation laws must exhibit sufficient elasticity to accommodate novel financial arrangements

> so questions such as what is property and what is a source were approached with an eye to both the true legal nature and the adaptability of tax laws to the moving target of financial innovation
Hayes (cont’d)

> there are no taxable dispositions from a source during the life of the convertible hedge triggering either a deductible loss or income or capital gain – the only source is the convertible hedge itself

> a square peg does fit into a round hole if the round hole is big enough

> In CCLI (1994) Inc, Miller T.C.J. said

   “I have attempted on previous occasions to mesh legal and economic realities for the purpose of making sense of our complex tax legislation: this approach has not been universally embraced. Certainty and legal form do trump economic substance, if legal form reflects legal substance.”
Manrell
2003 (FCA) – W

> consideration for a promise not to compete is not proceeds of disposition of property

> quote from Shell that “finding unexpressed legislative intentions under the guise of purposive interpretation runs the risk of upsetting the balance Parliament has attempted to strike in the Act”

> it is not acceptable to stretch statutory language in a taxing statute in order to achieve what may appear to be a reasonable result in a particular case

> result changed by section 56.4