Federal Court of Appeal  Cour d'appel fédérale

Date: 20191210

Docket: A-187-18

Citation: 2019 FCA 306

CORAM: **WEBB J.A.**
NEAR J.A.
LASKIN J.A.

BETWEEN:

626468 NEW BRUNSWICK INC.

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Halifax, Nova Scotia, on October 30, 2019.

Judgment delivered at Ottawa, Ontario, on December 10, 2019.

REASONS FOR JUDGMENT BY: WEBB J.A.

CONCURRED IN BY: NEAR J.A.
LASKIN J.A.

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REASONS FOR JUDGMENT

WEBB J.A.

[1] The issue in this appeal is whether subsection 55(2) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the Act) applies to a dividend that 626468 New Brunswick Inc. (626 NB) was deemed to have received on December 18, 2006 in the amount of $569,093. The corporation that was deemed to have paid this dividend had previously sold its assets and the issue that was argued before the Tax Court of Canada was whether the safe income on hand of the payor corporation should reflect the income taxes payable as a result of this disposition of its assets.

The Tax Court found that the payor's safe income should be reduced by the tax liability that arose as a result of the disposition of its assets (2018 TCC 100). As a result, the appeal of 626 NB to the Tax Court (from the assessment that was issued on the basis that subsection 55(2) of the Act applied to the deemed dividend referred to above) was dismissed.

[2] On appeal to this Court, 626 NB argued that subsection 55(2) of the Act should not apply to the deemed dividend in issue based on a textual, contextual and purposive analysis of subsection 55(2) of the Act.

[3] For the reasons that follow, I would dismiss this appeal.

I. Background

[4] As a preliminary comment, I would note that there are some discrepancies between certain amounts as disclosed by the record and the amounts used by the parties and the Tax Court Judge. These discrepancies will be highlighted as reference is made to these amounts in these reasons.

[5] In 2006, Rodney Gillis owned an apartment building in Saint John, New Brunswick. He was interested in selling this property and he sought advice from an accountant in Toronto with respect to how the transaction should be structured. To that end, the accountant prepared a memorandum dated August 17, 2006 (the Memo), which outlined the various steps that should be completed in relation to the sale of the real property.

[6] For the purposes of this appeal, it is not necessary to describe in detail all of the steps that were in the Memo. The following is a summary of the key steps that are relevant to the analysis in this case.

[7] The first step was the transfer of the land and building from Rodney Gillis to Tri-Holdings Limited (a corporation formed by Rodney Gillis under the laws of New Brunswick) on a tax-deferred basis under section 85 of the Act. Because the outstanding amount of the mortgage on the property exceeded the aggregate of the adjusted cost base of the land and the undepreciated capital cost of the building, Tri-Holdings only assumed the portion of the outstanding mortgage on the property that was equal to the aggregate of these amounts. It appears, based on the agreement related to the transfer of the shares of Tri-Holdings to 626 NB and the related T2057 election form filed by Rodney Gillis under section 85 of the Act, that Tri-Holdings issued four common shares to Rodney Gillis. However, the balance sheet for Tri-Holdings dated November 3, 2006 states that only three common shares were issued. Since it is immaterial for the purposes of this appeal whether three or four common shares of Tri-Holdings were issued, it will be assumed that four common shares were issued.

[8] Rodney Gillis then transferred his four common shares of Tri-Holdings to 626 NB. He filed an election form under section 85 of the Act in relation to this transfer of shares. Since the adjusted cost base of the common shares of Tri-Holdings was only a nominal amount, the elected amount on this transfer was also a nominal amount. 626 NB issued four common shares to Rodney Gillis as consideration for his transfer to it of the common shares of Tri-Holdings.

[9] Tri-Holdings sold the land and building to an arm's length purchaser for $5,829,000. As a result of selling the land and building for this amount, Tri-Holdings realized a capital gain and recaptured capital cost allowance. The parties had submitted a "Partial Statement of Agreed Facts" to the Tax Court in which the parties agreed that one-half of the capital gain realized on the disposition of the property was $1,319,500; and that the other one-half of the capital gain, together with recaptured capital cost allowance, totalled $3,079,184. This would mean the total capital gain that was realized on the sale of the property was $2,639,000 and that the total recaptured capital cost allowance was $1,759,684.

[10] From December 13 to December 17, 2006, Tri-Holdings increased its paid-up capital by the total amount of $1,879,120 (not including the amount related to the capital dividend). Each of these increases in the paid-up capital resulted in a deemed dividend being paid by Tri-Holdings to 626 NB (subs. 84(1) of the Act) and a corresponding increase in the adjusted cost base of the shares of Tri-Holdings held by 626 NB (para. 53(1)(*b*) of the Act). During this period, Tri-Holdings also increased its paid-up capital by $1,319,500, which was the balance in its capital dividend account (as defined in subs. 89(1) of the Act). Tri-Holdings filed the election to treat the deemed dividend arising as a result of this increase in the paid-up capital as a capital dividend under subsection 83(2) of the Act. The capital dividend reflects the non-taxable half of the capital gain realized on the disposition of the assets by Tri-Holdings. The capital dividend also resulted in an increase in the adjusted cost base of the shares of Tri-Holdings held by 626 NB (para. 53(1)(*b*) of the Act).

[11] In the Memo, it was contemplated that the shares of Tri-Holdings (that were held by 626 NB) would be sold to an arm's length purchaser. In order to increase the adjusted cost base of the shares of Tri-Holdings to the amount that the third party purchaser would be paying to 626 NB, Tri-Holdings increased its paid-up capital by the additional amount of $569,093 on December 18, 2006.

[12] The timing of the completion of the steps after December 18, 2006 is not clear. However, it appears that the following additional steps were completed on or before December 31, 2006:

- Tri-Holdings issued voting preferred shares to a U.S. corporation (that, according to the Memo, was to be owned by 626 NB) which resulted in Tri-Holdings ceasing to be a Canadian-controlled private corporation, as defined in subsection 125(7) of the Act;
- 626 NB sold its shares in Tri-Holdings to an arm's length purchaser;
- Tri-Holdings was continued under the laws of British Columbia and changed its name to 0778285 BC Limited; and
- Tri-Holdings / 0778285 BC Limited acquired certain software from Securitas Video Corporation and claimed a deduction that resulted in its income for the year ending December 31, 2006 being reduced to nil.

[13] The Minister of National Revenue denied the claim by Tri-Holdings / 0778285 BC Limited for the deduction related to the acquisition of the software. The only information available in relation to this claim is that Tri-Holdings / 0778285 BC Limited had objected to this denial of its claim for a deduction related to the software.

[14] The only issue before the Tax Court and this Court is in relation to the final deemed dividend arising as a result of the increase in the paid-up capital of the shares of Tri-Holdings on December 18, 2006 in the amount of $569,093.

II. Decision of the Tax Court

[15] The only argument that was raised before the Tax Court related to the computation of the safe income on hand immediately prior to the payment of the last dividend. In particular, the argument was restricted to whether the taxes that would be payable by Tri-Holdings as a result of the disposition of the real property would reduce the safe income on hand at that time. The Tax Court referred to the decisions of Justice Bell in *Deuce Holdings Limited v. The Queen*, 97 DTC 921, 1997 CarswellNet 1240 and this Court in *Kruco Inc. v. Canada*, 2003 FCA 284, 308 N.R. 108 and concluded that the safe income was reduced by the income tax liability of Tri-Holdings related to the disposition of its assets.

III. Issue and Standard of Review

[16] In this appeal, 626 NB raises the issue of whether subsection 55(2) of the Act would apply to the dividend in this case based on a textual, contextual and purposive analysis of this provision. Since this issue relates to the interpretation of a provision of the Act, the standard of review is correctness (*Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235).

IV. Analysis

[17] As noted above, at the Tax Court hearing, the focus was only on the narrow question of whether safe income should be reduced by the amount of taxes payable but not yet paid. In this appeal, 626 NB broadened the scope of issues by arguing that, based on a textual, contextual and purposive analysis, subsection 55(2) of the Act did not apply to the final deemed dividend paid on December 18, 2006. An integral part of this issue is whether the safe income on hand, immediately before this deemed dividend was paid, would reflect the unpaid tax liability related to the disposition of assets by Tri-Holdings.

[18] Subsection 55(2) of the Act is an anti-avoidance provision that, in certain situations, will convert what would otherwise be an intercorporate dividend that will not be subject to tax into a taxable capital gain. In 2006, subsection 55(2) of the Act read as follows:

(2) Where a corporation resident in Canada has received a taxable dividend in respect of which it is entitled to a deduction under subsection 112(1) or 112(2) or 138(6) as part of a transaction or event or a series of transactions or events, one of the purposes of which (or, in the case of a dividend under subsection 84(3), one of the results of which) 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	(2) Dans le cas où une société résidant au Canada a reçu un dividende imposable à l'égard duquel elle a droit à une déduction en vertu des paragraphes 112(1) ou (2) ou 138(6) dans le cadre d'une opération, d'un événement ou d'une série d'opérations ou d'événements dont l'un des objets (ou, dans le cas d'un dividende visé au paragraphe 84(3), dont l'un des résultats) a été de diminuer sensiblement la partie du gain en capital qui, sans le dividende, aurait été réalisée lors d'une disposition d'une action du capital-actions à la juste valeur marchande immédiatement avant le dividende et qu'il serait raisonnable de considérer

income earned or realized by any corporation after 1971 and before the safe-income determination time for the transaction, event or series, notwithstanding any other section of this Act, the amount of the dividend (other than the portion of it, if any, subject to tax under Part IV that is not refunded as a consequence of the payment of a dividend to a corporation where the payment is part of the series)	comme étant attribuable à autre chose qu'un revenu gagné ou réalisé par une société après 1971 et avant le moment de détermination du revenu protégé quant à l'opération, à l'événement ou à la série, malgré tout autre article de la présente loi, le montant du dividende (à l'exclusion de la partie de celui-ci qui est assujettie à l'impôt en vertu de la partie IV qui n'est pas remboursé en raison du paiement d'un dividende à une société lorsqu'un tel paiement fait partie de la série):
(a) shall be deemed not to be a dividend received by the corporation;	a) est réputé ne pas être un dividende reçu par la société;
(b) where a corporation has disposed of the share, shall be deemed to be proceeds of disposition of the share except to the extent that it is otherwise included in computing such proceeds; and	b) lorsqu'une société a disposé de l'action, est réputé être le produit de disposition de l'action, sauf dans la mesure où il est inclus par ailleurs dans le calcul de ce produit;
(c) where a corporation has not disposed of the share, shall be deemed to be a gain of the corporation for the year in which the dividend was received from the disposition of a capital property.	c) lorsqu'une société n'a pas disposé de l'action, est réputé être un gain de la société pour l'année au cours de laquelle le dividende a été reçu de la disposition d'une immobilisation.

[19] "Safe-income determination time" is defined in subsection 55(1) of the Act :

safe-income determination time for a transaction or event or a series of transactions or events means the time that is the earlier of	***moment de détermination du revenu protégé*** Quant à une opération, à un événement ou à une série d'opérations ou d'événements, le premier en date des moments suivants :
(a) the time that is immediately after the earliest disposition or increase in interest described in any of subparagraphs 55(3)(a)(i) to 55(3)(a)(v) that resulted from the	a) le moment après la première disposition ou la première augmentation de participation, visée à l'un des sous-alinéas (3)a)(i) à (v), qui a résulté de

transaction, event or series, and	l'opération, de l'événement ou de la série;
(b) the time that is immediately before the earliest time that a dividend is paid as part of the transaction, event or series;	b) le moment avant le premier versement de dividende dans le cadre de l'opération, de l'événement ou de la série.

[20] In 2006, subsection 55(3) of the Act provided certain exceptions for the application of subsection 55(2) of the Act. However, since it was clearly contemplated when the paid-up capital increases were implemented that the shares would be sold to an arm's length third party, and the sale took place less than two weeks after the last increase in the paid-up capital, the exceptions in subsection 55(3) of the Act are not applicable. Neither party referred to these exceptions.

[21] The Supreme Court of Canada, in *Canada Trustco Mortgage Co. v. The Queen*, 2005 SCC 54, [2005] 2 S.C.R. 601, has set out the approach that is to be adopted in interpreting statutory provisions:

> 10 It has been long established as a matter of statutory interpretation that "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament": see *65302 British Columbia Ltd. v. Canada*, [1999] 3 S.C.R. 804, at para. 50. The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words play a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.

A. *Textual Analysis*

[22] Subsection 55(2) of the Act is a long, complex provision. In order to complete the textual analysis, it is necessary to unpack the conditions that are contained therein. The following conditions are contained within this single subsection:

1. a Canadian resident corporation has received a dividend;

2. that corporation is entitled to a deduction under subsections 112(1) or (2) or 138(6) of the Act in relation to that dividend;

3. the dividend is received as part of a transaction or event or a series of transactions or events;

4. one of the purposes or one of the results of that dividend was to significantly reduce a portion of the capital gain that would be realized if any share were to be sold for fair market value:

    - for any deemed dividend referred to in subsection 84(3) of the Act arising as a result of a redemption, purchase or cancellation by a corporation of its shares, it is the result of that dividend that is relevant; and

    - for any other dividend, it is the purpose of that dividend that is relevant;

5. the relevant time for the hypothetical sale of shares is immediately before the dividend is paid and the fair market value of the particular share is to be determined as of this time;

6. it is reasonable to consider that the portion of the capital gain that has been reduced is attributable to anything other than income that has been earned or realized after 1971 and before the safe income determination time by any corporation; and

7. there is an exception (which is not applicable in this case) related to a portion of the dividend that is subject to Part IV tax that is not refunded as described in this subsection.

[23] The income described in subsection 55(2) of the Act that has been earned or realized, and which would be reflected in a capital gain that would be realized on a fair market value sale of shares, has been commonly referred to as "safe income". The common acceptance of this term is reflected in the name assigned to the term "safe-income determination time" defined in subsection 55(1) of the Act.

[24] In this particular case, as noted above in paragraph 14, the only dividend that is in question is the last dividend that was deemed to be paid on December 18, 2006. 626 NB accepted that this dividend resulted in a significant reduction in the capital gain that would have been realized on a disposition at fair market value of the shares of Tri-Holdings. 626 NB also acknowledged at the Tax Court hearing and in this hearing that the purpose of this deemed dividend was to reduce the capital gain that would be realized on the sale of the shares of 626 NB to the arm's length purchaser. The only dispute is whether the capital gain that was reduced was attributable to safe income or whether, based on a textual, contextual and purposive analysis, subsection 55(2) of the Act should not apply to the deemed dividend paid on December 18, 2006.

[25] The starting point for this analysis is the determination of the capital gain that would have been realized if the deemed dividend would not have been paid. The application of subsection 55(2) of the Act is predicated on determining the amount of this capital gain and then allocating this capital gain between two sources - the portion of the capital gain that can be explained based

on the safe income and the portion that is attributable to something else. Dividends can be paid without attracting the application of subsection 55(2) of the Act if such dividends only reduce the portion of the capital gain that is attributable to safe income. The relevant capital gain is based on the difference between the fair market value of the shares in question and the adjusted cost base of these shares.

[26] The analysis required to determine if, based on the text of subsection 55(2) of the Act, this subsection applies to the final deemed dividend paid on December 18, 2006, will involve the following steps:

(a) the fair market value of the shares of Tri-Holdings immediately before this final deemed dividend is paid will be determined;

(b) the adjusted cost base of the shares of Tri-Holdings held by 626 NB immediately before this final deemed dividend is paid will be determined;

(c) the capital gain that would be realized on a disposition of the shares of Tri-Holdings held by 626 NB immediately before this final deemed dividend is paid will be determined;

(d) the safe income of Tri-Holdings as of the safe-income determination time will be determined, and in particular, whether the safe income is reduced by the taxes payable by Tri-Holdings as the result of its disposition of its assets; and

(e) the safe income on hand as of the time immediately before the final deemed dividend is paid will be determined.

(1) *Determination of the Fair Market Value of the Shares*

[27] The relevant shares in this case are the shares of Tri-Holdings held by 626 NB and the relevant time for the determination of the fair market value of these shares is immediately before the payment of the dividend on December 18, 2006 that is in issue in this appeal. There is no indication in the pleadings filed with the Tax Court that the fair market value of the shares was an issue that was to be determined by the Tax Court. There was no discussion of the fair market value of these shares at the Tax Court hearing and the Tax Court Judge did not make any finding with respect to the fair market value of these shares. Since it was not an issue, there were no expert reports on the valuation of the shares and, therefore, this case is distinguishable from *VIH Logging Ltd. v. Canada*, 2003 TCC 732, [2004] 2 C.T.C. 2149 (which is discussed more fully below).

[28] 626 NB noted at the Tax Court hearing and during the hearing of this appeal that, because the transactions as outlined in the Memo were not followed as set out therein, there were two rectification orders that were brought before the Court of Queen's Bench of New Brunswick. One of the matters addressed in the rectification applications related to the failure of 626 NB to issue shares to Rodney Gillis as consideration for the shares of Tri-Holdings that he transferred to 626 NB. This failure to issue shares was rectified by the Court.

[29] As part of the documents that were filed in relation to this rectification application, Rodney Gillis submitted his affidavit. One of the exhibits to this affidavit was a copy of the T2057 election form that he had filed with the Canada Revenue Agency in relation to his transfer

of the shares of Tri-Holdings to 626 NB. In this form, he indicated that the fair market value of the four common shares of Tri-Holdings that were transferred to 626 NB on November 30, 2006 was $5,829,000. It appears, however, that $5,829,000 was the selling price of the apartment building that was sold by Tri-Holdings. This amount would not reflect the amount of the mortgage on this property that was assumed by Tri-Holdings. Therefore, this amount would not be the fair market value of the common shares of Tri-Holdings.

[30] At the hearing of this appeal, 626 NB submitted that the fair market value of these shares was the amount that was received from the third party purchaser. 626 NB did not make any argument that the fair market value of the shares of Tri-Holdings, immediately before the final increase in paid-up capital on December 18, was any less than this amount. Although the Tax Court Judge noted that 626 NB had sold its shares of Tri-Holdings for $3,767,616, according to Schedule 6 to the T2 tax return for 626 NB, it sold its four common shares in Tri-Holdings (identified as 0778285 BC Ltd. in this Schedule) for the amount of $3,707,165 and its preferred shares of this company for $10. This Schedule also reveals that 626 NB claimed a capital loss of $60,551 on the disposition of the common shares of Tri-Holdings. Neither party raised any issue related to the increase in the adjusted cost base of the shares of Tri-Holdings to an amount that resulted in a capital loss on the disposition of the shares. There is no indication of whether this capital loss was denied as a result of the application of subsection 112(3) of the Act.

[31] In the “Partial Statement of Agreed Facts”, the parties agreed that 626 NB had sold its shares of Tri-Holdings to an arm’s length purchaser. Since the issue of the actual fair market value of the shares was not a matter that was put before the Tax Court, for the purposes of this

appeal the fair market value will be assumed to be the amount paid by the third party purchaser or $3,707,165. Since there is nothing to indicate that the assets held by Tri-Holdings changed between December 13 and December 18, 2006, it will be assumed that the fair market value of its shares did not change during this period. Therefore, the fair market value of the shares of Tri-Holdings, immediately before the deemed dividend was paid on December 18, 2006, will be assumed to be $3,707,165.

[32] Using this amount as the fair market value is also consistent with the often-cited definition of fair market value adopted by Justice McIntyre in *Re Mann Estate*, 1972 CanLII 1603 (B.C.S.C.), 1 N.R. 518:

> 13 I may add that I find nothing in the authorities to dispute or question the definition of "fair market value" adopted by Mr. Anson-Cartwright, called by the respondent, which appears in Ex. 2 in these terms:
>
> > 'fair market value' is the highest price available estimated in terms of money which a willing seller may obtain for the property in an open and unrestricted market from a willing, knowledgable purchaser acting at arm's length.

[33] The appeal of that case to the British Columbia Court of Appeal was dismissed (*Mann Estate v. British Columbia (Minister of Finance)*, 1973 CanLII 1628 (B.C.C.A.), 1 N.R. 516). A further appeal to the Supreme Court of Canada was also dismissed (*Re Mann*, 1974 CanLII 1730 (SCC), [1974] 2 W.W.R. 574). In the short oral reasons dismissing the appeal, Justice Martland, who delivered the reasons on behalf of the Supreme Court, noted, “[w]e are of the view that there was no error on a point of law in the reasons of the learned trial Judge”.

(2) *Determination of the Adjusted Cost Base of the Shares*

[34] The relevant time for the determination of the adjusted cost base of the shares of Tri-Holdings, held by 626 NB, is immediately before the last deemed dividend. Prior to this deemed dividend, as noted in paragraph 10 above, Tri-Holdings increased the paid-up capital of these shares in stages from December 13 to 17, which resulted in corresponding dividends and increases in the adjusted cost base of these shares. The paid-up capital increases, which resulted in taxable dividends, totaled $1,879,120. The additional paid-up capital increase, which resulted in a capital dividend, was $1,319,500. Therefore, the adjusted cost base of these shares was increased by the total amount of $3,198,620 ($1,879,120 plus $1,319,500).

(3) *Determination of the Capital Gain*

[35] Based on a fair market value of $3,707,165, a disposition of the shares of Tri-Holdings (immediately before the final dividend was paid) for proceeds of disposition equal to this amount would result in a capital gain of $508,545 ($3,707,165 - $3,198,620). This does not reflect the nominal adjusted cost base of the shares before the increases in the paid-up capital as that nominal amount would not affect the result in this appeal. It is also not clear whether that amount should be $3 (as reflected in the Balance Sheet for three common shares) or $4 (for four common shares as reflected in various other documents).

(4) *Determination of the Safe Income as of the Safe Income Determination Time*

[36] While the capital gain that would be realized on a fair market value sale of the shares is to be determined immediately before the dividend in question, the income that could reasonably be considered to contribute to that capital gain is the income earned or realized prior to the safe income determination time. The safe-income determination time would be immediately before the first dividend was deemed to be paid as part of the series of transactions, which would be immediately before the first increase in the paid-up capital on December 13, 2006.

[37] The question is, therefore, to what extent could the income earned or realized prior to December 13, 2006 reasonably be considered to be reflected in the capital gain that would be realized on a fair market value sale of the shares immediately before the final paid-up capital increase on December 18, 2006? The parties agreed in their "Partial Statement of Agreed Facts" that the income of Tri-Holdings, for the purposes of the Act, arising from the sale of its real property was $3,079,184. This disposition of assets occurred prior to December 13, 2006. The taxes arising as a result of this disposition of assets were not paid prior to the increases in paid-up capital that were completed during the period from December 13 to December 18, 2006. The issue is whether it is reasonable to consider that the amount of income that would contribute to a capital gain arising on a sale of shares of Tri-Holdings would be reduced by these taxes.

[38] In *Deuce Holdings*, Justice Bell made the following comments in relation to whether the taxes payable on the income earned would be taken into account in determining safe income:

> 30. Unhappily, it seems that one must journey beyond the words in section 55 in order to determine whether the computation 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 a 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.
>
> …
>
> 32. Before tax profit is not wholly distributable. Although it is dangerous to speculate on what the legislation was intended to mean, I conclude that in this case it is only the portion of the "income earned or realized" by the dividend paying corporation remaining *after* tax that should be included in computing "safe income".

[39] I agree with the comments of Justice Bell in *Deuce Holdings* that it would only be logical that any arm's length third party purchaser of shares would take into account any existing tax liability of the corporation, even though such liability may not be payable until a later date. In this case, the tax liability arose as a result of the disposition by Tri-Holdings of its real property. Any tax liability of Tri-Holdings would remain with Tri-Holdings following a sale of its shares.

[40] In *VIH Logging*, 401277 B.C. Ltd. (401 BC) carried on a helicopter logging business on Vancouver Island. Prior to the taxation year in issue, 401 BC had not earned any significant profit (paragraph 29 of the reasons of Justice Woods (as she then was)). It appears that 401 BC projected significant profit for its taxation year ending March 1, 1993. To reduce its tax liability, a series of transactions was completed. As part of these transactions, 401 BC became a wholly-owned subsidiary of VIH Logging. 401 BC sold its helicopter logging business to VIH Logging

for an assumption of liabilities and a promissory note. The transfer of the business by 401 BC resulted in “little taxable gain” to 401 BC (paragraph 34).

[41] 401 BC paid three dividends to its then-parent company, VIH Logging – two cash dividends in the total amount of $1,397,429 ($980,629 + $416,800) and a stock dividend in the amount of $366,079. Since 401 BC had not earned any significant profit prior to the year during which these dividends were paid, the issue was whether 401 BC’s safe income could be determined for a stub period that ended before 401 BC’s taxation year ended. The actual computation of the amount of safe income, and whether it was to be determined before or after tax, was not in issue.

[42] The reasons do not explicitly state whether the safe income amount, as calculated by the taxpayer in *VIH Logging*, was computed as the profit before tax or after tax. Paragraph 47 of the reasons states:

> VIH Logging's computation of safe income included the helicopter logging profits for most of 1993 even though 401277 had no taxable income for the year because of the seismic deduction.

[43] However, based on the information as disclosed in the decision, it is possible to confirm that the safe income amount, as determined by the taxpayer, was the income after taxes. As noted above, the first year in which there were any significant profits was the year in question. The safe income amount, as calculated by the taxpayer, was $1,397,429 (paragraphs 35 and 58 of the reasons). The taxes, arising as a result of the income earned during the year in question, were $938,080 (paragraph 35). If the safe income amount is the income of 401 BC before taxes, then

the effective tax rate would be 67% ($938,080 / $1,397,429). To the extent that the safe income amount may include any profit from a previous year, the effective tax rate applicable to the income earned in the current year would be even higher. If the safe income amount was calculated as the income after taxes, the income before taxes would then be $2,335,509 ($1,397,429 + $938,080) and the effective tax rate would be 40% ($938,080 / $2,335,509). As a result, it seems clear that since the tax rate would not have been 67%, the safe income amount of $1,397,429 reflected the taxes payable on the income earned by 401 BC for the stub period.

[44] In *VIH Logging*, the plan included the acquisition of seismic data, which would result in a tax deduction that would eliminate 401 BC's tax liability for its March 1, 1993 taxation year. However, in *VIH Logging*, the taxpayer argued (and the Tax Court accepted) that the fair market value of the shares of 401 BC, immediately before the payment of the stock dividend, should reflect the liability for taxes, even though such taxes would not ultimately be paid as a result of a subsequent acquisition of seismic data (paragraphs 64 and 65 and footnote 18). If the tax liability is not taken into account in valuing the shares of 401 BC, then (since this was its only liability and since 401 BC had sufficient cash to cover this liability of $938,030) the fair market value of the shares of 401 BC would be significantly more than the nominal amount as found by the Tax Court. As a result of the finding in *VIH Logging* that the fair market value of the shares of 401 BC was only a nominal amount before the stock dividend was paid, subsection 55(2) of the Act did not apply to this dividend; not because this dividend was covered by safe income, but rather because there was no significant gain on the shares that was reduced as a result of the payment of this dividend (paragraphs 65 and 66).

[45] In dismissing the appeal, this Court in *Canada v. VIH Logging Ltd.*, 2005 FCA 36, [2005] 4 F.C.R. 61, stated:

> 38 However, the availability to the recipient corporation of an offsetting dividend deduction does not depend upon the paying corporation having actually paid any tax. The reason may be that there are numerous legitimate reasons why a corporation may have the capacity to pay a dividend out of current earnings, while having no current tax liability by the time the year ends. That could happen, for example, if the corporation suffers unanticipated business losses after paying the dividend. It could also happen if the corporation is entitled to take advantage of certain incentives in the *Income Tax Act*, as occurred in this case when Old VIH acquired seismic data which entitled it to a deduction that deferred its 1993 tax liability. I conclude that the Crown's principal argument is based on a false premise. It is simply not true that subsection 55(2) is intended to ensure that tax-free intercorporate dividends are limited to post-1971 earnings on which tax has actually been paid.

[46] In reading these comments, it is important to bear in mind that the computation of the amount of safe income (and in particular whether the amount of safe income should reflect the taxes payable but not yet paid) was not in issue in *VIH Logging*. As noted above, the amounts as stated in the reasons of the Tax Court for the safe income and the taxes payable clearly confirm that the safe income amount reflected the tax payable. Since the only issue was whether the income earned in the current year (on which tax had not yet been paid) could be included in the computation of safe income, these comments are simply a confirmation that such income (even though tax has not yet been paid) can be included in the computation of safe income.

[47] In *Kruco*, the issue was whether certain adjustments should be made to safe income in relation to the investment tax credits of Kruco and one of its subsidiaries. At the beginning of the analysis, this Court stated:

> 31 In my respectful view, the Tax Court Judge came to the correct conclusion, essentially for the reasons that he gave and that I have attempted to summarize in the preceding paragraphs.

[48] In summarizing the reasons of the Tax Court Judge, Justice Noël (as he then was) noted:

> 21 In *Deuce Holdings*, Judge Bell found that a negative adjustment to safe income could be made for tax paid or payable. At page 931, he said:
>
> > It is logical that subsection 55(2) take into account the fact that proceeds that would, but for a 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.

[49] The following general comments in paragraph 38 of *Kruco* must be read in light of the earlier comments, and in light of the point that the issue in *Kruco* was not whether the liability for unpaid taxes would reduce safe income:

> 38 There can be no doubt that this exercise calls for an inquiry as to whether "the income earned or realized" was kept on hand or remained disposable to fund the payment of the dividend. It follows, for instance, that taxes or dividends paid out of this income must be extracted from safe income (see *Deuce Holdings Ltd., supra* and *Gestion Jean-Paul Champagne Inc., supra*).

[50] *Kruco* does not stand for the proposition that only taxes that have actually been paid will reduce safe income.

[51] In this case, the sale of real property by Tri-Holdings (that resulted in a taxable capital gain and recaptured capital cost allowance) occurred prior to the safe-income determination time. The amount of such tax liability could be, and was calculated. Although the taxes arising from the sale of its assets were not payable as of the relevant time for determining the safe income of Tri-Holdings, the safe income of Tri-Holdings, as of that time, would reflect these taxes.

[52] For the purposes of subsection 55(2) of the Act, the capital gain that has been reduced is to be determined based on the capital gain that would have been realized if the shares would have been sold, for an amount equal to their fair market value, immediately before the dividend in question is paid. Both the fair market value of the shares and the portion of the resulting capital gain that would be attributable to the income earned or realized would reflect the tax liability that, although not payable immediately, would eventually have to be paid. There is no indication that, as of the time immediately before the dividend in issue was paid, the tax liability of Tri-Holdings would have been any less than the amount as calculated by the Canada Revenue Agency.

[53] This tax liability would not disappear if, as contemplated by subsection 55(2) of the Act, the shares of Tri-Holdings would have been sold immediately before the dividend in question. Therefore, in valuing the shares of Tri-Holdings at that time, this tax liability would have been taken into account. The income that could reasonably be considered to contribute to this fair market value (and hence to a capital gain that would be realized on a disposition for this fair market value) would reflect the taxes payable as result of earning or realizing that income.

[54] The subsequent acquisition of the software by Tri-Holdings / 0778285 BC Limited is not a factor that should be taken into account in determining the fair market value of the shares of Tri-Holdings as of the relevant time. Nor is it a factor that should affect the determination of what portion of the capital gain (that would have been realized on a sale of the shares of Tri-Holdings, at that time, at fair market value) would be attributable to any income earned or realized. The only evidence that is in the record is that the deduction, which had been claimed in relation to the acquisition of the software, was denied. Although there is evidence that an objection was filed, it would simply be speculative whether the company would be successful in its objection or appeal to the Tax Court.

[55] In any event, even if the deduction related to the subsequent acquisition of the software would have been allowed, this would raise the question of why the reduction in the tax liability should be taken into account in determining safe income, but not the reduction in income that would occur as a result of claiming a deduction for capital cost allowance. It would seem logical that if the income is to be determined as of the safe income determination time, then the tax liability of the company should also be determined as of the same time.

[56] 626 NB does not dispute that the amount of taxes that resulted from the recaptured capital cost allowance and the taxable capital gain realized by Tri-Holdings was the amount as computed by the Canada Revenue Agency, which was $1,081,586. There is nothing to indicate that, if the shares of Tri-Holdings would have been sold to an arm’s length purchaser at the safe income determination time, the tax liability of Tri-Holdings would not have been the amount computed by the Canada Revenue Agency (or a greater amount). The amount at that

time may have been greater. It would appear that the actual tax liability as calculated by the Canada Revenue Agency was less than the amount that the accountants for Tri-Holdings had determined and may have taken into account a reduction in taxes payable as a result of the change in status of Tri-Holdings that occurred after December 18, 2006.

[57] In any event, any capital gain that would have been realized on a fair market value sale of the shares of Tri-Holdings would have reflected, as an amount for the tax liability that Tri-Holdings would have incurred as a result of the sale of its assets, at least the amount as determined by the Canada Revenue Agency.

[58] Therefore, the portion of the capital gain that would have been attributable to income earned or realized (safe income) prior to the payment of the first dividend would be equal to the net amount after taxes realized by Tri-Holdings on the disposition of its real property. This would mean that the safe income prior to the payment of any deemed dividends would have been equal to the income realized on the disposition of the assets ($3,079,184), minus the tax payable as a result of this disposition of assets ($1,081,586), which would be $1,997,598. Although there is no dispute with respect to the income realized on the disposition of the assets by Tri-Holdings, and no dispute with respect to the amount of the tax liability related to this disposition of assets, both in the Reply and in the reasons of the Tax Court Judge, the safe income amount was stated to be $1,998,098. This is a minor difference of $500 and does not affect the outcome of this appeal, as the amount of the assessment could not, in any event, be increased on an appeal to the Tax Court or this Court (*Harris v. Minister of National Revenue,*

[1965] 2 Ex. C.R. 653 at para. 17, 64 D.T.C. 5332, and *Petro-Canada v. The Queen*, 2004 FCA 158 at paras. 65 and 68, 319 N.R. 261).

(5) *Determination of the Safe Income on Hand as of December 18, 2006*

[59] The relevant capital gain in this case is the capital gain that would have been realized if the shares of Tri-Holdings would have been sold immediately before the last dividend was deemed to be paid on December 18, 2006. The transactions that preceded this dividend (which resulted in the adjusted cost base of the shares being increased) are relevant in determining the amount of the remaining safe income that could be considered to contribute to this capital gain. Each paid-up capital increase that was completed during the period from December 13 to December 17 resulted in a crystallization of the safe income as part of the adjusted cost base of the shares of Tri-Holdings held by 626 NB and would reduce the safe income on hand.

[60] This crystallization of the safe income can be explained by examining the effect of the increases in the paid-up capital of the shares of Tri-Holdings. Before the first increase in the paid-up capital, the fair market value of the shares would be the same amount as assumed above. All of the increases in the paid-up capital were accomplished simply by resolutions of the sole director of Tri-Holdings. The assets of Tri-Holdings did not change.

[61] Immediately prior to the first increase in the paid-up capital, the adjusted cost base of the shares of Tri-Holdings held by 626 NB was a nominal amount. Therefore, the capital gain that

would have been realized on a fair market value disposition of the shares of Tri-Holdings prior to the first increase in paid-up capital would, in essence, have been equal to the fair market value of the shares. That capital gain would have been approximately $3,707,165 and $1,997,598 of this capital gain would have been attributable to the income earned or realized by Tri-Holdings.

[62] Prior to December 18, the paid-up capital of the shares of Tri-Holdings was increased in stages. The deemed dividends arising as a result of these increases in paid-up capital can be divided into two types of dividends – taxable dividends and the capital dividend. Taxable dividends would be included in the income of 626 NB under paragraph 12(1)(*j*) and subsection 82(1) of the Act, and a corresponding deduction would be claimed under subsection 112(1) of the Act. The capital dividend would not be included in the income of 626 NB as a result of paragraph 83(2)(*b*) of the Act and there would be no corresponding deduction under subsection 112(1) of the Act. The capital dividend, therefore, would not be a dividend as described in subsection 55(2) of the Act.

[63] The paid-up capital increases and corresponding deemed dividends (other than the capital dividend) that were completed from December 13 to December 17 (which would not include the last increase in the paid-up capital that is the subject of this appeal) increased the adjusted cost base of the shares by $1,879,120. All of these increases in the adjusted cost base (and, therefore, reduction of the capital gain) would be attributable to the safe income of Tri-Holdings and therefore, subsection 55(2) of the Act did not apply to the deemed dividends that resulted in these increases in the adjusted cost base of the shares. The additional increase, as a result of the deemed capital dividend, added another $1,319,500 to the adjusted cost base of the shares. The

total adjusted cost base of the shares, immediately before the final increase in the paid-up capital, was $3,198,620.

[64] Therefore, immediately prior to the final increase in paid-up capital, the capital gain that would then have been realized on a fair market value sale of the shares of Tri-Holdings, as noted in paragraph 35 above, would have been $508,545 ($3,707,165 - $3,198,620). The adjusted cost base of the shares, at that time, reflected $1,879,120 of safe income that had been crystallized into that adjusted cost base. Therefore, the only portion of this capital gain that would be attributable to safe income would be the difference between the safe income determined as of the safe income determination time, as noted in paragraph 58 above ($1,997,598); and the safe income that was crystallized in the adjusted cost base of shares as noted above ($1,879,120), or $118,478. Although the final increase in paid-up capital was completed as one addition to the stated capital of the shares, in reassessing 626 NB credit was given for the then remaining safe income on hand, as determined by the Canada Revenue Agency.

[65] Because this final deemed dividend of $569,093 significantly reduced the capital gain that would have been realized by 626 NB on a fair market value sale of its shares, and this reduction was not attributable to income earned or realized, subsection 55(2) of the Act was applicable.

(6) *Determination of Safe Income in the Memo*

[66] It should also be noted that the calculation of the safe income as the income earned or realized, minus the taxes that would be payable in relation to that income, is consistent with the Memo. In the Memo, the author stated at paragraph 6 of the "Technical Steps", "[t]his safe surplus will comprise the taxable portion of the disposition of the property, less the tax liability as calculated above". The tax liability calculated above estimated the taxes as $1,400,000 based on the estimated taxable income of $3,500,000.

(7) *Retained Earnings as Disclosed in the Balance Sheet*

[67] This amount for safe income would also be consistent with the balance sheet prepared for Tri-Holdings as of November 3, 2006, which shows retained earnings of $3,198,620. For accounting purposes, these retained earnings would include the non-taxable portion of the capital gain. When the non-taxable portion of the capital gain is deducted, the retained earnings would be $1,879,123. The estimated taxes on the balance sheet were shown as $1,200,564. The retained earnings of $3,198,620 is equal to the total amount by which the adjusted cost base of the shares was increased ($3,198,620) before the final increase in the paid-up capital of $569,093 that was completed on December 18, 2006 and which is the subject of the dispute in this appeal. As noted above, this final increase in the paid-up capital was only completed so that the adjusted cost base of the shares would match the amount to be paid by the third party purchaser.

B. *Contextual and Purposive Analysis*

[68] 626 NB argued that applying subsection 55(2) of the Act to the final deemed dividend is not consistent with the context and purpose of this subsection. However, I do not agree with this submission of 626 NB. Subsection 55(2) of the Act is an anti-avoidance provision that prevents a corporate shareholder from converting what would otherwise be a taxable capital gain on a disposition of shares into an intercorporate dividend that would be deductible under subsection 112(1) of the Act. The context and purpose of this provision is to allow a person to reduce the capital gain by an amount that reflects any income that has been earned or realized under the Act. Income earned under the Act will result in taxes payable and this will be reflected in the fair market value of the shares and in the portion of the capital gain (that would be realized on a sale of shares for this fair market value) that is attributable to income earned or realized. Any purchaser would take into account any existing tax liability of a corporation that such person is purchasing.

[69] In this case, 626 NB argued that there were no assets in Tri-Holdings that had an untaxed appreciation in value, and that the purpose of subsection 55(2) of the Act was to prevent taxpayers from effectively converting any untaxed appreciation in value into a dividend that would be deductible under subsection 112(1) of the Act. However, subsection 55(2) of the Act is based on analyzing the capital gain that would be realized on a fair market value sale of shares and then determining what portion of that capital gain is attributable to safe income. Therefore, for the purposes of subsection 55(2) of the Act, the explanation for the amount of the capital gain is divided into two categories – safe income and something else.

[70] In this case, there is an unexplained capital gain equal to the difference between the amount paid by the third party purchaser and the net assets of Tri-Holdings. As confirmed during the hearing of this appeal, the only significant assets of Tri-Holdings at the relevant time were cash received from the sale of its property and an amount due from its shareholder. There would be no inherent unrealized capital gain in these assets. A valuation based solely on the amount of these assets and the liabilities of Tri-Holdings (which would include the liability for taxes as acknowledged by the accountants for Tri-Holdings in the balance sheet dated November 3, 2006) would presumably yield a significantly lower amount for the fair market value of the shares than the amount paid by the arm's length purchaser. The balance sheet prepared by the accountants for Tri-Holdings indicates that, as of November 3, 2006 (which was after the real property was sold), the retained earnings of Tri-Holdings were $3,198,620 (which is significantly less than the purchase price of $3,707,165 that was paid for the common shares).

[71] If the fair market value of the shares of Tri-Holdings was less than $3,707,165 on December 18, 2006, this may raise questions with respect to whether the final paid-up capital increase was valid under the *Business Corporations Act*, S.N.B. 1981, c. B-9.1.

[72] However, 626 NB did not raise any issue, either at the hearing before the Tax Court or in this appeal, with respect to whether the fair market value of the shares may have been less than $3,707,165 on December 18, 2006. In this appeal, 626 NB argued that the fair market value of the shares of Tri-Holdings should be the amount paid by the third party purchaser. For the reasons as noted above, this is assumed to be the fair market value of the shares of 626 NB. Using the amount paid by the arm's length purchaser as the fair market value of the shares of

Tri-Holdings distinguishes this case from *VIH Logging* where the taxpayer argued that the fair market value of the shares of 401 BC, immediately prior to the payment of the stock dividend, was only a nominal amount, even though the shares were sold for a significant amount, a short time later.

[73] It is too late now for 626 NB to raise any argument that would or could result in a valuation of the shares being less than the amount paid by the arm's length third party purchaser. As a result, there is a capital gain that would be realized on a sale of the shares of Tri-Holdings for $3,707,165 immediately before the last increase in the paid-up capital that cannot be explained by any income earned or realized by Tri-Holdings. In my view, taxing this unexplained capital gain (by effectively converting the dividend that would otherwise have eliminated this gain into a capital gain) is within the context and purpose of subsection 55(2) of the Act.

[74] The means by which this dividend is effectively converted into a capital gain is as follows. Paragraph 55(2)(*a*) of the Act provides that the amount in issue is deemed to not be a dividend. As a result, there is no addition to the adjusted cost base of the shares for this amount under paragraph 53(1)(*b*) of the Act. The subsequent sale of the shares for $3,707,165 results in an increased capital gain (because the adjusted cost base of the shares is lower). Since this amount in question is otherwise reflected in the amount paid by the third party, no additional amount would be added to the proceeds under paragraph 55(2)(*b*) of the Act.

V. Conclusion

[75] As a result, I would dismiss the appeal with costs. The parties, after the hearing, confirmed that they had reached an agreement on costs and that the successful party would be entitled to costs fixed in the amount of $1,500 (inclusive of disbursements). I would therefore fix costs in the total amount of $1,500, inclusive of disbursements.

"Wyman W. Webb"
J.A.

“I agree
D. G. Near J.A.”

“I agree
J.B. Laskin J.A.”

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

APPEAL FROM A JUDGMENT OF THE TAX COURT OF CANADA DATED MAY 25, 2018, CITATION NO. 2018 TCC 100 (DOCKET NO. 2014-4756(IT)G)

DOCKET:	A-187-18
STYLE OF CAUSE:	626468 NEW BRUNSWICK INC. v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	HALIFAX, NOVA SCOTIA
DATE OF HEARING:	OCTOBER 30, 2019
REASONS FOR JUDGMENT BY:	WEBB J.A.
CONCURRED IN BY:	NEAR J.A. LASKIN J.A.
DATED:	DECEMBER 10, 2019

APPEARANCES:

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