

[OFFICIAL ENGLISH TRANSLATION]

96-1458(IT)G
96-1459(IT)G

BETWEEN:

RALPH E. FARAGGI,
ROBERT LANGLOIS,

Appellants,

and

HER MAJESTY THE QUEEN,

Respondent.

Motion heard on February 8, 2002, at Montréal, Quebec, by

The Honourable Alban Garon
Chief Justice

Appearances

Counsel for the Appellants: Guy Du Pont
Alan Shragie
Marie-Emmanuelle Vaillancourt

Counsel for the Respondent: Daniel Marecki

ORDER

The Appellants applied to the Court under section 58 of the *Tax Court of Canada Rules (General Procedure)* for a ruling on the following question of law:

[TRANSLATION]

subsection 83(2) of the *Income Tax Act*, S.C. 1970-71-72 c. 63 as amended (the "*I.T.A.*"), when read with subsection 184(2) of the *I.T.A.*, is it consistent with the reassessments made against the Appellants to the effect that the dividends in respect of which private corporations of which they were shareholders elected under subsection 83(2) of the *I.T.A.* in the prescribed manners and forms and in the particular time were assessed as "taxable" dividends.

The Court ruled that while there is a *prima facie* inconsistency between the assessments under appeal and subsection 83(2) of the *Income Tax Act* when read with subsection 184(2) of the *Act*, it is essential to determine whether or not the elections under subsection 83(2) of the *Act* by the corporations involved in the pleadings in these appeals are a "sham" or whether they are a series of operations leading up to a "sham".

The response to the Appellants' question under section 58 of the *Tax Court of Canada Rules (General Procedure)* does not put an end to the case. A hearing on the merits of these appeals will be necessary.

Costs will be in the appeals.

Signed at Ottawa, Canada, this 18th day of September 2002.

"Alban Garon"

C.J.T.C.C.

Translation certified true
on this 16th day of March 2004.

Maria Fernandes, Translator

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Date: 20020918
Dockets: 96-1458(IT)G
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BETWEEN:

RALPH E. FARAGGI,
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Respondent.

REASONS FOR ORDER

Garon, C.J.T.C.C.

[1] This is a motion by the Appellants under section 58 of the *Tax Court of Canada Rules (General Procedure)* for the Court to rule on a question of law before the hearing on the merits of appeals of assessments for the 1987 and 1988 taxation years. This application was made in a notice of motion dated November 30, 2001.

[2] Through those assessments, the Minister of National Revenue added to each Appellant's reported income for the 1987 year as taxable dividends the amounts of \$8,114,350.07 in the case of Appellant Robert Langlois and \$8,034,165.93 in the case of Appellant Ralph E. Faraggi. For the 1988 taxation year, the Minister of National Revenue added \$155,912.00 to the earnings reported by each of the

two Appellants as taxable dividends. Through these assessments, the Minister of National Revenue also assessed interest and penalties for those same two years.

[3] It is not in dispute that on different dates throughout the 1987 taxation year, four private corporations paid dividends on their shares to both Appellants. One of the four corporations also paid dividends in 1988 on its shares to both Appellants.

[4] The question of law is set out as follows:

[TRANSLATION]

subsection 83(2) of the *Income Tax Act*, S.C. 1970-71-72 c. 63 as amended (the "*I.T.A.*"), when read with subsection 184(2) of the *I.T.A.*, is it consistent with the reassessments made against the Appellants to the effect that the dividends in respect of which private corporations of which they were shareholders made an election under subsection 83(2) of the *I.T.A.* in the prescribed manners and forms and in the time period were assessed as "taxable" dividends.

[5] The procedure regarding the motion under section 58 of the *Rules, supra*, is twofold. During the first step, the applicant must establish the right to apply to the Court for a ruling on a question of law prior to the hearing of the appeals.

[6] In this case, the Respondent agreed that the Court first rule on the question of law. Accordingly, I issued an order dated December 12, 2001, setting out certain matters relating to factums to be filed by the parties prior to the motion hearing and setting the hearing date for this motion.

[7] I deem it appropriate to refer to the grounds submitted by the Appellants in their Notice of Motion:

[TRANSLATION]

THE GROUNDS FOR THIS MOTION ARE AS FOLLOWS:

- (a) Parliament, under subsection 83(2) of the *I.T.A.*, clearly and unambiguously, established that "no part of the dividend (at issue in each case and in respect of which an election was made) shall be included in computing the income of any shareholder of the corporation", "aucune partie du

dividende n'est incluse dans le calcul du revenu de tout actionnaire de la corporation";

- (b) the only prerequisites to the application of subsection 83(2) relative to dividends payable in every case at issue are restricted to the evidence of filing of prescribed forms within the timeframe set out in the *I.T.A.*, conditions that are in no way contested by the Respondent in his pleadings:
- (c) consequently, the assessments are simply prohibited by subsection 83(2); and
- (d) furthermore, the determination of this question
 - (i) only implies a question of law that does not depend on a determination of questions of fact; and
 - (ii) shall completely dispose of these appeals without a trial at relatively little cost and in a relatively short time for both the parties, as well as for the Court.

Appellants' Arguments

[8] On behalf of the Appellants, it was argued that the rule set forth in subsection 83(2) of the *Income Tax Act* is simple, imperative and unqualified and does not vary from one shareholder to another. They argued that the only elements required for the application of subsection 83(2) of the *Act* relate to the fact that a dividend be payable to shareholders and that the corporation made an election. The Appellants pointed out that the Respondent admitted that the amounts received were dividends and that the elections were made by the corporations involved within the prescribed time and in accordance with the prescribed form. Therefore, according to the Appellants, the dividends received by them under these circumstances could not be included in computing their income.

[9] After indicating that subsection 184(2) of the *Act* sets forth the consequences of an election made in respect of a dividend that exceeds the part of which is deemed to be a capital dividend, the Appellants' senior counsel argues that nothing in that subsection sets forth the consequences of an election in respect of the shareholder. A taxpayer or corporation is not required to make a reasonable attempt to determine his or its capital dividend account in order to be entitled to benefit from subsections 184(3) and 184(3.2) of the *Act*.

[10] The same counsel for the Appellants mentioned that Parliament could have, in formulating an anti-avoidance rule relative to capital dividends in subsection 83(2.1) of the *Act*, provided for its retroactive application to the period covered under these appeals.

[11] With regard to the Respondent's argument that there is a "sham", the Appellants argue that this concept cannot be applied to the Applicants because they did not present the Minister of National Revenue with facts that do not reflect reality. The Respondent does not deny that the Appellants received dividends. The "sham" concept does not apply in respect of the elections set out in subsection 83(2) of the *Act*. This election was made within the time and in the prescribed form.

[12] According to the Appellants, it is important to note that for the purposes of applying subsection 83(2) of the *Act*, there simply needs to be a dividend and not a capital dividend and that the election be made in respect of a dividend. According to the Appellants' senior counsel, a dividend may be a "sham" but the Respondent is not claiming that the dividends received by the Appellants were a "sham". The same counsel continues by arguing that the application of paragraph 83(2)(b) of the *Act* depends on the existence of the dividend, not on the existence of the capital dividend account.

[13] The Appellants' senior counsel adds that the Court's jurisdiction issue is *res judicata* in order to rule on the question of law given the Court Order dated December 12, 2001.

Respondent's Arguments

[14] Counsel for the Respondent argues that on the basis of the assessment, the Minister of National Revenue recognizes it as a dividend. According to the Minister, this is the only way to process amounts received by Appellants. He argues that there was "fabrication of a dividend", or of a capital dividend account, a "sham" set up to generate business income and that the election was only part of that fabrication. According to the Minister, to rule otherwise would be to allow a taxpayer who is both responsible for a "sham" to also take advantage of an election in a "sham" to avoid personal tax assessment.

[15] According to the Respondent, "the election made pursuant to subsection 83(2) is one of the steps or is the final step leading up to the 'sham'".

Counsel for the Respondent advances that the election may not be set up against the Minister because the Court must assume that everything flows from an operation that is a "sham". In the Minister's opinion, a "sham" corrupts everything.

[16] The Respondent argues that all of the circumstances leading up to the election must be taken into account. As everything flows from a "sham", the Minister of National Revenue was justified in considering the election as non-existent. In the absence of an election, there is no non-taxable dividend. In his view, election has no legal value. Furthermore, according to the Respondent, the fact that the Minister of National Revenue assessed the dividends does not result in the validation of an election which he deems non-existent.

[17] In reference to the extent of subsection 83(2) of the *Act*, counsel for the Respondent said the following at paragraphs 24 and 25 of the document entitled [TRANSLATION] "Outline of the Respondent's Argument...":

[TRANSLATION]

24. With respect for the contrary opinion, absolute rules are rare in tax law and we believe that this is not the extent of subsection 83(2) of the I.T.A. even when read in combination with subsections 89(1)(j), 184(2) and 185 of the I.T.A.
25. The absolute extent of the principle appears to us as highly doubtful in the following example:

A corporation that, in bad faith and without a shadow of a doubt, received no capital dividends from other corporations, realized no disposition of property even possibly giving the appearance of a capital gain (basically, absolutely nothing in the "cda") and that despite those facts and circumstances decided to pay a dividend and call it a capital dividend, hence believing to put the dividend (and the shareholder receiving it) in a total personal tax shelter because the election may not, in any case, in its entirety, be set up against the Minister.

We believe that election could not be set up against the Minister given the absence of any apparent substance that may justify the election.

[18] As regards the facts that must be assumed to reply to the question of law, counsel for the Respondent is of the opinion that the judge will have to determine whether or not this is a "sham". The Respondent, agreeing to move on to the second phase of the procedure set out in section 58 of the *Rules* is not dropping as such the "sham" argument. The Court, according to the Respondent, in ruling on the question of law, cannot presume that the election is valid. It must consider the existence or non-existence of a "sham" in order to resolve this question.

Analysis

[19] Prior to discussing the application of subsection 83(2) of the *Act* respecting capital dividends, I find it useful to broach the general treatment of dividends set out by the *Income Tax Act*. This act provides for two types of dividends: the taxable dividend and the tax-free dividend. The taxable dividend is defined in paragraph 89(1)(j) as follows:

(1) In this subdivision,

...

- (j) "taxable dividend" means a dividend other than
 - (i) a dividend in respect of which the corporation paying the dividend has elected in accordance with subsection 83(1) as it read prior to 1979 or in accordance with subsection 83(2), and
 - (ii) a qualifying dividend paid by a public corporation to shareholders of a prescribed class of tax-deferred preferred shares of the corporation within the meaning of subsection 83(1).

This definition clearly establishes that dividends are generally taxable but exceptions apply, including the type of dividend set out in subsection 83(2) of the *Act*, namely capital dividends.

[20] If the dividend is taxable, it is included in the income under paragraphs 12(1)(j) and 82(1)(a) of the *Act*. Paragraph 82(1)(b) of the *Act* sets out that the sum included in income as taxable dividends must be raised by one quarter or one third, depending on the taxation year at hand, if the taxpayer is an individual. The individual is entitled to a tax credit under section 121 of the *Act* set

out in accordance with the increase and set at two thirds of the increase during the relevant period.

[21] These general remarks lead me to the special regime of capital dividends.

[22] First of all, only a private corporation may pay tax-freed capital dividends for the shareholder.

[23] In order to pay a capital dividend, a private corporation must make an election under subsection 83(2) of the *Act* by submitting a prescribed form within the given time.

[24] The question asked in the Appellants' motion, reduced to its simplest form, is to determine whether or not the assessments under appeal are consistent with subsection 83(2) of the *Act*.

[25] To determine this question, one must first refer to subsections 83(2) and 184(2) of the *Act*, which read as follows at the relevant time:

83(2) Where at any particular time after 1971 a dividend becomes payable by a private corporation to shareholders of any class of shares of its capital stock and the corporation so elects in respect of the full amount of the dividend, in prescribed manner and prescribed form and at or before the particular time or the first day on which any part of the dividend was paid if that day is earlier than the particular time, the following rules apply:

- (a) the dividend shall be deemed to be a capital dividend to the extent of the corporation's capital dividend account immediately before the particular time; and
- (b) no part of the dividend shall be included in computing the income of any shareholder of the corporation.

184(2) Where a corporation has elected in accordance with subsection 83(2), 130.1(4) or 131(1) in respect of the full amount of any dividend payable by it on shares of any class of its capital stock and the full amount of the dividend exceeds the portion thereof deemed by that subsection to be a capital dividend or capital gains dividend, as the case may be, the corporation shall, at

the time of the election, pay a tax under this Part equal to $\frac{3}{4}$ of the excess.

[26] The conditions for application of subsection 83(2) of the *Act* are simple. They may be summarized into three proposals:

1. A dividend must be payable by a private corporation to the shareholders.
2. The corporation makes an election relative to the total dividend amount.
3. The election is made according to terms and conditions set out by regulations within the time set out in that subsection.

[27] There is no doubt that the corporations in question seemingly met the three aforementioned conditions. However, the Respondent believes that the elections made by the corporations under subsection 83(2) of the *Act* cannot be set up against the Minister of National Revenue by both the corporations having paid out dividends or by the Appellants. In this respect, the Respondent refers to the Replies to the Notices of Appeal, particularly paragraph 2 of each of those Replies. Paragraph 2 reads in part as follows:

[TRANSLATION]

2. . . . and adds to the surplus:

- (a) that companies "2528", "1915", "1276" and "1292" did not, in good faith, establish a capital dividend account;
- (b) these companies had no capital dividend to pay their shareholders, including the Appellant:
- (c) the election set out in paragraph 83(2) of the *Income Tax Act* made by companies "2528", "1915", "1276" and "1292" cannot be set up against the Minister of National Revenue since these elections are an integral part of a scheme ("sham") set up by Robert Langlois and Ralph E. Faraggi, who used a chain of corporations to fabricate capital gains, thereby fictitiously creating a capital dividend account for the purpose of reselling said capital dividend account to third parties for a profit.

[28] The Respondent raises yet another fundamental question in his Replies to the Notices of Appeal concerning the application of subsection 83(2) of the *Act*, that is, whether the elections made by the private corporations involved are an integral part of the "sham". At the hearing of that question, under section 58 of the *Tax Court of Canada Rules (General Procedure)*, the Respondent put forward, in the same vein, the argument that elections made by the corporations in question constituted, as part of a certain number of operations, the final step of a "sham" and that accordingly, they could not be set up against the Minister of National Revenue.

[29] I add that the determination on the "sham" issue in respect of elections, for the purposes of applying subsection 83(2) of the *Act*, appears to me to be perfectly relevant because if the elections were part of a smokescreen or constituted a "sham", they would likely not be valid.

[30] I will note that the Court was not asked to determine whether or not the elections made by private corporations pursuant to subsection 83(2) of the *Act* constituted a "sham" and could not be set up against the Minister of National Revenue, which would involve a question of mixed fact or law. The question of law that is before me at this stage rests rather on the consistency of assessments with the provisions of subsection 83(2) of the *Act*.

[31] While at first glance it flows from my analysis that there is an inconsistency between the assessments under appeal and subsection 83(2) of the *Act*, when read with subsection 184(2) of the *Act*, it is essential to determine whether or not the elections by private corporations under subsection 83(2) of the *Act* constituted a "sham" or are an integral part of a series of operations leading up to a "sham". The response to the question on which the Appellants applied to the Court for a ruling pursuant to section 58 of the *Tax Court of Canada Rules (General Procedure)* cannot, therefore, put an end to the case. Accordingly, a hearing on the merits of these appeals will be necessary.

[32] Costs will be in the appeals.

Signed at Ottawa, Canada, this 18th day of September 2002.

"Alban Garon"

C.J.T.C.C.

Translation certified true
on this 16th day of March 2004.

Maria Fernandes, Translator