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CDA Anti-avoidance case

The case of Groupe Honco Inc. v. The Queen, 2012 TCC 305 (CanLII) dealt with the question of whether capital dividends received by three companies in a corporate chain at the end of a series of transactions could be deemed not to be capital dividends by subsection 83(2.1) of the Act. This subsection is a specific “anti-avoidance” provision that was introduced in 1988 to curtail trading in CDA – acquiring shares of a company that has a CDA balance in order to be able to pay capital dividends to the acquirer.

The current case facts can be summarized as follows:

- A corporation within a group of companies that were involved in the case built a $600,000 structure for Oldco
- Oldco was owned and controlled, directly or indirectly by Mr. B
- Mr. B became terminally ill and Oldco started having financial difficulties and was unable to pay for the structure
- Oldco then agreed to rent the structure from the group but then quickly could not continue to make the rental payments
- Mr. L, the principal of the group and the controlling shareholder of the chain of companies involved in the case, made an offer to Mr. B and Oldco to purchase Oldco’s inventory, to lease all Oldco business assets, to have the trade name used by Oldco transferred to Newco and to have the option to acquire all the shares of Oldco
- Shortly thereafter an inventory was done, formal written contracts providing for rental of the business assets with an option to purchase them and an option to purchase the shares were signed;
- Mr. L managed the business of Oldco and it returned to profitability
- Newco exercised the options to buy the business assets and shares of Oldco
- Newco and Oldo then amalgamated
- Oldco owned life insurance on Mr. B
- Mr. B died and Oldco (now Newco which had amalgamated with Oldco) received life insurance proceeds resulting in a CDA credit
- Some of the life insurance proceeds were paid to creditors of Oldco
- $200,000 of the life insurance proceeds were used to pay a capital dividend by Oldco on preferred shares held by Mr. B’s widow
- The CDA balance of $750,000 was paid as a capital dividend from Newco to Groupe Honco Inc. and then from that company to Gestion Paul Lacasse Inc. (all companies within the group controlled by Mr. L).

The Court considered whether the capital dividends received by each of the companies in the chain at the end of the series of transactions described above were part of a series of transactions, one of the main purposes of which was to receive the (capital) dividend. The Court said yes and denied capital dividend treatment on the dividends.

The companies stated that the rationale for the purchase of the shares was to be able to recover the significant investment in the construction of the structure, to continue certification to carry on the special business of Oldco and to acquire the losses of Oldco to carry forward against the future income of Newco. While the Judge agreed these were purposes of the series, he found that the availability of Oldco’s remaining capital dividend account was also a main purpose of the series of transactions. Mr. L knew about the life insurance policy and did not say he had “never” discussed the life insurance policy or the possible distribution of the proceeds tax free after Mr. B’s death. He only stated that he had never heard of the CDA until after the use of Oldco’s losses was settled.

Key advisors who may have known of the CDA and its importance in the sale did not testify. In the end, the Judge was “unable to conclude that the taxpayers have discharged their burden of proof of establishing that the assessments were incorrect and that the acquisition of the capital dividend account, the value of which resided in its eligibility for distribution by way of capital

dividend, was not among the principal purposes for New Supervac's (Newco) acquiring the Old Supervac (Oldco) shares."

This is an interesting case. It is the first case involving the CDA anti-avoidance provision. Unfortunately, it does have "bad facts." It was hard for the Judge to ignore the obvious – terminal illness, life insurance proceeds, purchase of shares of the company, amalgamation and payment of capital dividends through a chain of companies in quick succession and with no one offering testimony or anything in writing about the CDA part of the transactions.

One problem I have with the case is that it appears that an available argument to the taxpayers was not used. Yes, the CDA anti-avoidance rule undoes a capital dividend if a main purpose of the purchase of the shares is to acquire the CDA so that a capital dividend can be paid. But, the anti-avoidance provision "does not apply in respect of a dividend … where it is reasonable to consider the purpose of paying the dividend was to distribute an amount that was received by reason of paragraph (d) of the definition of 'capital dividend account' in subsection 89(1)." That reference is to the receipt of life insurance proceeds by a private corporation. There is no discussion or mention of this exception from the application of the CDA anti-avoidance rule in the case. We do not know if the taxpayer raised the argument at all at the Tax Court. A notice of appeal has been filed in the Federal Court of Appeal and the exception provision is raised as an argument by the taxpayer in it. I could be wrong, but the way I read the Act, if you are into an exception, you're out of the specific CDA anti-avoidance rule. You might still be in GAAR – the general anti-avoidance rule – but the CRA would have to use that provision, not the specific one in this section. Is this exception preserved through an amalgamation and through payment of a capital dividend through a chain of companies? Again, I could be wrong, but the way I read the Act, the exception could be preserved if the creation of the capital dividend in Oldco (now Newco) was one to which the anti-avoidance provision would not have applied if Newco did not exist. The intent was expressed in the explanatory notes accompanying the legislation when it was introduced to preserve the exception for CDA derived from life insurance proceeds even if capital dividends are paid up through a chain of companies. But I'm wondering, is there a technical gap in the exception provisions even though there appears to be the intent?

I guess we will have to wait and see how the exceptions interact with the specific anti-avoidance rules and whether we will need to see another case like this to further flesh this out.

These columns are current as of the time of writing, but are not updated for subsequent changes in legislation unless specifically noted.

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