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ARTICLE

FCA confirms GAAR applies to limited partner capital dividend tax plan

On September 14, 2020, the Federal Court of Appeal (FCA) released its decision dismissing the taxpayer's appeal of the Tax Court of Canada (TCC) decision in *Gladwin Realty Corporation v The Queen*.[1] The FCA found that the General Anti-Avoidance Rule (GAAR) applied to deny the taxpayer the tax benefit obtained through a complex series of transactions.

What you need to know

- The FCA determined that the taxpayer defeated the rationale underlying the capital dividend account (CDA) regime through its use of the negative adjusted cost base (ACB) rules applicable to limited partnership interests (the Negative ACB Rules).
- The FCA found that the key reason the series of transactions constituted abusive tax avoidance under GAAR was because the taxpayer ceased operations immediately after the series of transactions. This decision left a negative CDA balance, and Gladwin would never have to forgo capital dividends on future additions to CDA as it resets to zero.
- The legislative provision calculating CDA was amended in 2013 to exclude the impact of the Negative ACB Rules, which the FCA found did not reflect new law. Rather, the Court found the amendments were consistent with an existing policy that the Negative ACB Rules have a neutral impact on the CDA balance.
- As a result of the FCA decision, Gladwin will have its CDA balance reduced by $12 million and will be assessed a penalty for having made a capital dividend election in excess of its CDA balance. Gladwin will then have the opportunity to make an election under subsection 184(3) of the *Income Tax Act* (the Tax Act) to treat the excessive capital dividend as a taxable dividend to avoid the penalty.

Summary of court decisions

Background and facts

Gladwin Realty Corporation Inc. (Gladwin) was a Canadian-controlled private corporation (CCPC) in the real estate business whose ultimate individual shareholders were members of the same family. In 2007 and 2008, Gladwin wanted to sell land and a building located in Ottawa (the Real Estate Assets), with an inherent gain of approximately $24 million.

Rather than selling the Real Estate Assets directly to a purchaser for a taxable capital gain of $12 million and an addition to CDA of $12 million, Gladwin undertook a complex series of transactions involving a limited partnership. The inclusion of the limited partnership allowed Gladwin to use the Negative ACB Rules in subsections 40(3.1) and 40(3.12) of the Tax Act to control Gladwin's CDA balance.

Essentially, the limited partnership triggered one capital gain on the sale of the Real Estate Assets, and Gladwin extracted the value from the sale from the limited partnership. This extraction caused the ACB of its partnership interest to become negative, which triggered another capital gain under subsection 40(3.1).

Upon the partnership's allocation of the first capital gain to Gladwin, Gladwin could pay a $24 million capital dividend. Then, Gladwin elected under subsection 40(3.12) to trigger a capital loss, which reduced Gladwin's CDA balance to -$12 million. In other words, Gladwin was able to pay out the entire $24 million capital gain from the sale of the Real Estate Assets as a tax-free capital dividend (instead of half). As part of its transaction steps, Gladwin emigrated to the British Virgin Islands (BVI), losing its CCPC status in order to avoid paying refundable tax on its capital gains. Both Gladwin and the limited partnership ceased operations immediately following this series of transactions.

Tax Court of Canada decision

In order for GAAR to apply, there must be:

- a tax benefit;
- avoidance transactions; and
- the avoidance transactions must be abusive.[2]

Gladwin conceded that the tax benefit and avoidance transaction requirements of the GAAR test were met, so the TCC's analysis focused on whether there was abusive tax avoidance. Generally, the test for abusive tax avoidance under GAAR identifies the object, spirit or purpose of the tax provisions in question and analyzes whether the underlying rationale of such tax provisions has been frustrated or defeated.

The TCC determined that the object, spirit, and purpose of the CDA regime was to uphold the principle of integration, meaning that an individual realizing a capital gain directly should have the same tax consequences as if such individual realized the capital gain indirectly through one or more corporations. It also found that the Negative ACB Rules were intended to dissuade partnerships from making cash distributions to their limited partners in excess of their investment in the partnership. The accompanying subsection 40(3.12) election is intended to alleviate double taxation when the partnership then allocates taxable income to the partner at a later date.

The TCC found there was abusive tax avoidance because the result led to significant over-integration, where the tax implications on the sale of the Real Estate Assets through the corporations and limited partnership were not the same as if an individual shareholder had sold the assets directly.

Federal Court of Appeal decision

Although the TCC stated that avoidance of penalty tax on an excessive capital dividend was the tax benefit in this case, the FCA held that such a penalty could not be considered a tax benefit for purposes of the GAAR test because this penalty arose from the notice of determination applying GAAR.

The FCA stated that the purpose of a notice of determination is to deny a tax benefit, not bring one into existence. Therefore, Gladwin agreed to pay out the relevant capital dividends to its individual shareholders so that a tax benefit would arise in order to obtain a resolution to this matter. This is an interesting consequence of a prior decision of the FCA, holding that increasing a tax attribute in itself is not a tax benefit until such attribute is actually used to reduce tax.[3]

With respect to the abuse analysis, although the FCA agreed that the CDA rules aim to promote the principle of integration, it focused on a different part of the object, spirit and purpose of the CDA regime. In particular, the FCA noted that when amounts bring the CDA balance to a negative number, capital dividends cannot be paid out until the CDA balance becomes positive again. "…[T]he system is kept whole and its integrity is preserved by the fact that the CDA deficit will have to be compensated by additional qualifying amounts before a capital dividend can again be paid."[4] The FCA found that Parliament did not intend to stop corporations from paying out capital dividends between the year when the ACB of partnership interests are negative and the year when the ACB becomes positive again.

As for the Negative ACB Rules, subsections 40(3.1) and 40(3.12) are intended to work in conjunction, such that the effect is self-erasing and limited partners are not doubly taxed if the partnership remedies their negative ACB in a subsequent taxation year. The Negative ACB Rules were found to have operated exactly as they should have in respect of their underlying rationale.

However, in this case, Gladwin wound down its operations, meaning that it would not have to forgo any capital dividends as it undertook transactions that reset the negative CDA balance up to zero. Thus, it was Gladwin ceasing its operations that "breaks the integrity" of the CDA regime, making the transactions abusive under GAAR.

Other considerations

In 2013, the Tax Act was amended to exclude from the computation of CDA capital gains realized under subsection 40(3.1) and capital losses realized under subsection 40(3.12). Understandably, Gladwin argued that these amendments constituted new law that did not apply to the taxation year in which these transactions took place. The FCA disagreed on the basis that there already existed an observable policy where the Negative ACB Rules should have a neutral impact on CDA.

It is also interesting to note that neither the TCC nor the FCA spent much time on the matter of Gladwin emigrating to BVI. Both courts acknowledged that the purpose of continuing to BVI was to avoid refundable tax on aggregate investment income, which could not be recovered under this tax plan because the dividends paid were capital dividends and not taxable dividends. Commentary on the TCC decision noted that this fact did not receive any attention from the courts, although it is not clear whether one can infer that emigration from Canada to avoid refundable tax is therefore acceptable.[5]

Takeaways

Both the TCC and FCA indicate that previous GAAR cases manufacturing a "paper loss," where there has not been a real loss of economic value on a disposition of an asset used to offset taxable income, have historically attracted the application of GAAR. Similarly, Gladwin was able to isolate and benefit from the CDA addition on its deemed gain under the Negative ACB Rules and create a deemed capital loss under the same rules to offset the undesirable tax attributes. Taxpayers and their tax advisors should be wary of tax plans that involve the creation and isolation of tax attributes that asymmetrically reduce undesirable tax attributes while benefiting from the additional desirable tax attributes.

The FCA's focus on the inactivity of Gladwin as the determinative factor in the abuse analysis raises the question of whether it follows that GAAR would not have applied to taxpayers who leave a negative CDA balance for a long time, as long as they do not cease operations. We do not typically expect operating businesses to sell capital assets on a regular basis, so if Gladwin had owned another building or another piece of land and did not cease operations until years later, would this case have been decided differently?

Furthermore, although all parties agreed that the CDA regime does not preclude a taxpayer from selling two capital assets in such a way that could result in a negative CDA balance, it is less clear that a taxpayer can sell two capital assets to create the same negative CDA balance after paying out double the capital dividend.

These questions may have been resolved in favour of the Crown, based on the TCC's finding that GAAR applied because the transactions resulted in over-integration. However, a decision that overturned transactions on the basis of over-integration may have had far reaching negative consequences for taxpayers, which could have overly limited their ability to plan their tax affairs. The FCA's narrower approach to the abuse analysis appears to limit the application of this case, leaving more flexibility for taxpayers.

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[1] *Gladwin Realty Corporation v The Queen*, 2020 FCA 142 [*Gladwin Realty (FCA)*]. See also *Gladwin Realty Corporation v The Queen*, 2019 TCC 62.

[2] *Canada Trustco Mortgage Co. v Canada*, 2005 SCC 54.

[3] *1245959 Alberta Ltd. v. Canada (Attorney General)*, 2018 FCA 114.

[4] *Gladwin Realty (FCA)* at para 57.

[5] Anthony Strawson and Andrew Bateman, "CDA Extraction After Deemed Gain Followed by Deemed Loss Held To Be Abusive" (2019) 19:3 *Tax for the Owner-Manager* 1-2.

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