

# Federal Court of Appeal Upholds Broad Interpretation of Anti-Avoidance Provision Treating Certain Distributions as Dividends

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The Federal Court of Appeal has broadly interpreted an anti-avoidance provision ([subsection 84\(2\)](#)) in the Income Tax Act ([ITA](#)), that treats corporate property distributions or appropriations to shareholders occurring on the winding-up, discontinuance, or reorganizations, as dividends, affirming a Tax Court of Canada ruling ( [Foix v. Canada, 2023 FCA 38](#) ).

The taxpayers in this case (three individuals) each either held shares of a software company (Watch4Net) as trust beneficiaries or through holding companies. In 2012, the taxpayers implemented a hybrid sale of the Watch4Net's assets to another corporation (EMC Corp.) and its subsidiary (EMC Canada). In their 2012 tax returns, the taxpayers each reported a capital gain from the sale of Watch4Net's, and the holding company's, shares and claimed the capital gains deduction under [subsection 110.6\(2.1\)](#) of the ITA so as to fully offset the gain.

In 2017, the Minister of National Revenue issued reassessments, treating over CAD 3 million that the taxpayers received from the hybrid sale as dividends under subsection 84(2) of the ITA. The taxpayers appealed the reassessments, asserting that the conditions for the application of ITA subsection 84(2) were not met.

The Tax Court held that the property ruled against the taxpayers, ruling that ITA subsection 84(2) applies on the facts of the case because the following cumulative conditions had been met:

- funds or property were "distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders" of Watch4Net; and
- the distribution or appropriation occurred "on the winding-up, discontinuance or reorganization" of Watch4Net's business.

The taxpayers claimed that the trial judge erred in holding that the first condition of ITA subsection 84(2) was satisfied, (i.e. the requirement that a corporation impoverish itself for the benefit of its shareholders for there to be a distribution or an appropriation). According to the taxpayers, Watch4Net was not impoverished because it continued to hold all of its assets after their shares were sold and that the amounts that ended up in the taxpayers' hands through the hybrid sale came from the EMC group and not from Watch4Net.

The taxpayers also argued that Tax Court erred in finding that Watch4Net's business was reorganized and that the holding company's business was discontinued despite evidence showing that the EMC group assumed and pursued all of their operations. The taxpayers allege that the Tax Court misapplied

the test set out in Kennedy (FCTD) by disregarding the distinction between a corporate reorganization and the reorganization of the business carried on by that corporation.

In its 20 February 2023 Decision, the Federal Court of Appeal held that Watch4Net and the holding company were impoverished "as a result of the indirect distribution of its excess cash to the [taxpayers]. According to the Federal Court of Appeal, "the scope of [ITA] subparagraph 84(2) is wide enough to counter this type of distribution." The Federal Court of Appeal also held that the terms "winding-up, discontinuance or reorganization" under ITA subparagraph 84(2) must be construed broadly and thus, the Tax Court correctly ruled that Watch4Net was reorganized as a result of the hybrid sale and that the holding company's business was discontinued.

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